S. Hrg. 103–904

TREASURY DEPARTMENT'S SPRING 1994 REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

Y 4. B 22/3: S. HRG. 103-904

Treasury Department's Spring 1994 R...

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

THE OMNIBUS TRADE ACT OF 1988 THAT REQUIRES THE SECRETARY OF THE TREASURY TO SUBMIT A REPORT ON INTERNATIONAL ECONOMIC POLICY, INCLUDING EXCHANGE RATE POLICY, AND TO IDENTIFY IN EACH REPORT COUNTRIES THAT MANIPULATE THEIR EXCHANGE RATES TO GAIN UNFAIR TRADE ADVANTAGES WITH THE UNITED STATES

JULY 21, 1994

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

MAY 23 1995

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TREASURY DEPARTMENT'S SPRING 1994 REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

THURSDAY, JULY 21, 1994

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:35 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The Committee will come to order. I want to welcome all those in attendance this morning. Let me describe the focus of today's hearing and the purpose of having our witness before us today.

Under provisions of the Omnibus Trade Act of 1988, which were drafted by this Committee, the Secretary of the Treasury is required to submit to this Committee each 6 months a report on international economic policy, including exchange rate policy. We drafted these provisions to make sure that the Executive Branch makes the achievement of a healthy balance of trade a top priority item in our international economic negotiations. We also asked the Treasury Department to identify in each report those countries that manipulate their exchange rates to gain unfair trade advantages with the United States.

Obviously, those unfair trade advantages in that area hurt our country. They cause higher unemployment in the United States, and they do economic damage to America.

There has been much attention in the press in recent months about the decline of the dollar against the Japanese yen and what is causing this to happen. Some have speculated that it is a concern about potential future inflation that has caused the dollar to decline and that the cure is for the Fed to raise interest rates.

I don't accept that notion. Some put that forward, but I would say that there is scant evidence of higher inflation and I think higher interest rates at this time, further upward adjustments, would run a great risk of damaging our economic recovery.

I think today's report which is being presented confirms what is, in fact, the correct explanation for the dollar's decline against the yen. The report suggests that Japan will have an overall global trade surplus of over $130 billion this year. Of that $130 billion global trade surplus, some $60 billion will be with the United

States. There's really no excuse for that and it's enormously damaging to our country in many different ways.

These sorts of trade figures which are, I think, a part of a concerted, long-term, national strategy by Japan, are totally unacceptable, and I think they make it crystal clear that Japan is continuing to operate its economy in a manner that is detrimental to the world's trading system. It is an unacceptable exploitation and it goes on and on and on.

In a recent Washington Post article on the dollar's decline against the yen, Clyde Prestowitz said the heart of the problem comes from the fact that, and I quote:

> Japan wants to export without importing. It views a trade surplus as a sign of national strength.

That, said another way, in my own words, is precisely what we have seen over a long period of time, and that is the Japanese want access to our market and flood large amounts of their production in here and through a variety of devices, work very skillfully and steadily to make sure that we don't sell a corresponding amount of goods in Japan. The fact is, that on a $60 billion a year annual deficit basis, that's $5 billion a month leaving the United States and going to Japan. There's no excuse for it. It's really an outrageous situation and it goes on year after year.

The Japanese government, with all the instability and the turmoil and the bureaucrats and the manipulative trading practices, continue in this pattern, to the great detriment of this country.

Now, the fact is, when Japan runs huge trade surpluses with us, as it does, it collects a large amount of dollars that it does not then use to buy American imports. A decline of the dollar versus the yen reflects this reality. In fact, Robert Samuelson stated as much in an article in yesterday's Washington Post, and I quote him. He said:

> It represents a harsh judgment by global money managers that the Japanese cannot correct their big trade imbalance themselves and only large exchange rate changes will do the job.

In fact, Dr. Summers makes much the same point on page 5 of his testimony, where he states today:

> The perception that the new government of Japan might be less able to make substantial policy changes than its predecessor has fueled speculation that a rise in the yen will be required to effect the necessary external adjustment.

A second highly disturbing aspect of today's Treasury report is the fact that, once again, for the third straight year, China is identified as manipulating its currency to gain trade advantage.

In 1991, China's trade surplus with the United States was $12.7 billion. The next year it jumped from that level up to $18.3 billion. The year after that it jumped again to $22.8 billion. This year, it's expected to exceed $27 billion, all of this occurring while China has been manipulating its currency in order to capture United States markets and restrict the flow of American goods into China.

In effect, what China is doing is following the Japanese example of using unfair trading practices. They've just chosen principally a different device to accomplish the same end.

This, too, is, I think, and should be totally unacceptable behavior on the part of China. American workers who, for example, make

sporting goods, footwear, and clothing are losing their jobs and their livelihood in part because our Government continues to let China get away with this unfair practice. Because of it, we're also losing opportunities to expand American exports to China, and are in effect losing jobs that would be associated with these expanded exports.

Our Government, I think, must make halting the practice of exchange rate manipulation by China a top priority in our ongoing discussions with that country, and we want to talk with Dr. Summers about that today.

Let me yield now to Senator Sarbanes.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I'm also pleased to join with you in welcoming to the Banking Committee this morning the Under Secretary of the Treasury for International Finance, Lawrence Summers, for the testimony on the international economic policy, including the exchange rate policy.

As Chairman Riegle pointed out, the Omnibus Trade and Competitiveness Act of 1988 requires the Treasury to submit a report to Congress on international economic and exchange rate policy each year, with an update 6 months later.

Congress decided to require this report after the experience of the first half of the 1980's, in particular, when the Reagan Administration seemed to simply encourage or accept a very substantial appreciation of the dollar without really apparently—well, they may have focused on it. They didn't publicly, in a sense, announce it as a policy.

The result, in any event, was a dramatic decline of the United States trade balance from surplus to huge deficit. We went from being the largest creditor nation in the world to being the largest debtor nation. We have found ourselves depending, as Tennessee Williams said in one of his plays, on the kindness of strangers, and they're not often very kind in this economic realm.

It was estimated that American producers were working at a 30 to 40 percent price handicap because of the overvaluation of the American currency.

These reports which we're going to receive this morning work to improve the communication of the Administration with Congress, and through Congress to the public at large on what is seen by many as an obscure issue, but which really involves very vital public policy.

Today's hearing comes at a timely occasion. The United States trade balance is widening and, as I understand it, today's report projects that it will continue to rise until growth picks up amongst our trading partners.

Many of us see a primary purpose of the G–7 meetings to facilitate coordination of economic policies in order to promote stronger growth and, with the G–7 summit just concluded, we will be interested to hear the plans and prospects in that regard.

The exchange rate of the dollar versus the yen and the mark has recently been drawing a great deal of attention. As we had hoped when we fashioned this legislation under which the report is being

given this morning, the report tries to put the decline of the dollar versus those two currencies into a longer term and a wider context.

Apparently, and I'm interested that the Under Secretary will develop this in his testimony, or in questions, the dollar has appreciated against other currencies over this period of time, so that on a trade-weighted basis it stood only 2 percent lower at the end of June than it did 8 months before. I think that's a very important point, if, as I understand it, that's the state of events.

The 1988 legislation required the Treasury to report on countries that manipulate their currencies in order to gain an unfair advantage in the trade relationship. Earlier reports documented practices by Taiwan and Korea that artificially depressed their currencies in order to promote exports and impede imports. Subsequent discussions and negotiations with the United States Treasury has brought about reform in many of those practices.

The report this morning continues to find that the People's Republic of China is manipulating its currency. The United States trade deficit with China is growing rapidly. Over the last 12 months, our $9 billion in exports to China were barely a quarter of our $34 billion in imports from China.

I'm very struck by people who say, "Well, we have $43 billion worth of trade with China." Nine billion dollars of it is our goods going there and $34 billion of it is their goods coming here, for a trade imbalance of about $25 billion.

This has escalated in an extraordinary way. I don't think it's fully appreciated how this trade relationship is being manipulated by China, contrary to the standard rules of international trade, to gain an unfair advantage.

Beginning in about 1986, we began to get this escalation in the United States imports from China. Chinese goods coming into this country, they're now just shy of $34 billion.

Now, this is what has been happening to United States exports to China, an increase, but a relatively slight increase. This is what happens to the United States trade balance as a result of this gap.

So the trade balance is now negative at about $25 billion. That's the second largest trade imbalance we're running with any country in the world. The report today, as I understand it, finds that China is manipulating its currency to gain a trade advantage, and they also have other restrictions on the trading relationship.

Other major trading partners do not have such an imbalance between their exports and imports in trade with China. According to the official Chinese statistics, which gets into this argument about how you treat goods that move through Hong Kong, China has a wide trade surplus with the United States, but runs a trade deficit with Japan, with Taiwan, and with the European Community.

These are exports from China. These are imports into China.

Japan sends more into China than it takes from China. The European Community sends more into China than it takes from China. Taiwan sends more into China than it takes from China.

Here's the United States. Actually, what's happening is China is running a trade surplus with the United States and using the proceeds of that trade surplus in order to run a negative trade balance with Japan, the EC, and Taiwan. So, in an indirect way, the Unit-

ed States is, in effect, underwriting the exports that Japan and the EC are making to China. It's an incredible situation.

We're now in a deficit mode on the trade balance at $25 billion. Look at the movement of those lines. It's just incredible. This is what we're taking from China. This is what we're sending to China.

This report makes it very clear, in my judgment, that that's not simply the workings through the application of the ordinary rules of trade in international affairs. It's because this relationship is being manipulated and managed by the Chinese.

So, we end up running this trade imbalance, but the other countries are not doing it. Why not? I think they're probably harder on the trade relationship. They, in effect, are engaged in a certain amount of counter-managing as a strategy against these Chinese techniques. Obviously, it's a problem that needs to be addressed and I'm very much looking forward to the Under Secretary's testimony this morning.

Thank you.

The CHAIRMAN. Thank you very much, Senator Sarbanes. A very important presentation.

Let me ask unanimous consent that Senator D'Amato's statement be put in the record at this point. He's on the Senate Floor managing a bill and left to come over because he wanted to participate, but had to go back.

So, without objection, his statement will be made part of the record.

Senator Bond.

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you very much, Mr. Chairman. We're very pleased you're holding this hearing.

Yesterday, obviously, we had many questions that were raised and everybody told us, Under Secretary Summers, that you would be able to answer these questions. We are certainly looking forward to that.

Yesterday, when Chairman Greenspan testified before the Committee, he indicated that possibly the weak dollar was a sign of future inflation and, as we know, the market reacted strongly to this statement. It fell against the mark and the yen, both long- and short-term interest rates climbed, and the Dow Jones fell by 21 points.

We realize that monetary policy isn't the only factor at work here. It's very difficult to analyze all of these many factors. That's why we're delighted to have somebody of your capabilities to help solve these questions for us.

Anyone knowledgeable about international trade, of course, recognizes that we cannot expect in a world trade context to have a perfect bilateral balance with each country with which we trade, but we would welcome your comments with respect to particular problems that may have arisen.

I think we must have a strong and consistent economic policy that strengthens our dollar. We have to continue the recovery of our domestic economy. There are many factors at play in today's global economy, along with the declining dollar, the rising deficits,

the volatile financial markets, and also the question of leadership in international affairs.

I look forward to hearing your views on these issues and, again, we're happy to welcome you to this hearing.

Senator SARBANES. Mr. Chairman, I think I'd say to Under Secretary Summers, Senator Bond laid out all of the figures of the drop in the market perhaps as a consequence of Greenspan's testimony yesterday. We'll see if you can do as much today in the course of your testimony.

Senator BOND. Mr. Chairman, let us hope that perhaps he can provide some reassurance that will turn things around in the right direction.

Senator Sarbanes has laid out a tough challenge for you. I was not going to phrase it that way, but since he has offered that challenge, this will make your testimony even more interesting.

Mr. SUMMERS. Senator, if I might, I can report that the embargo on my testimony was broken at 10 a.m., and that before coming here at 10:30, I checked whether there had been any response. I was informed that the market had regarded my testimony as unremarkable and that there had not been a response.

Senator BOND. Perhaps the enlightened comments from the Banking Committee Members will have some impact on the market.

[Laughter.]

Mr. SUMMERS. Or the results of their probing questioning.

The CHAIRMAN. Thank you, Senator Bond.

Senator Domenici.

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Senator DOMENICI. Thanks, Mr. Chairman.

I'm not sure, Mr. Secretary, that I can stay, so it's not terribly fair for me to lay out a lot of thoughts and then not be here for your responses, but let me just try a couple that I hope you will explain.

First, there are a lot of things in the President's budget submittal that I don't think make too much sense with reference to interest rates. I'd like you to think about it and, if it's relevant to other people's questions, you might answer it.

In January, the Administration predicted that long-term interest rates would remain at 5.8 percent throughout the decade, or as far as the eye could see.

They were quite wrong. Long-term rates are now at 7.2 percent. There are various reasons for it. Obviously, you will explain that rather easily with reference to the Federal Reserve Board. Nonetheless, that wasn't a small error. It added up to $101 billion in Federal debt through 1999. That's my figures. I think they're right.

Last week, the Administration told us that they assume interest rates will remain at 7 percent throughout the decade. As I mentioned, they are at 7.2 percent now. I hope the Administration is correct, but I have trouble accepting these interest projections when we see growing investment markets overseas, and demand for the dollar declining against the yen, the Deutsche mark, and many other European and Asian currencies. Those seem to be rather inconsistent.

I don't know what the reason for the situation with reference to the American dollar overseas is. It seems to me that it is not something easily measured, and everybody seems to say the dynamics in the American economy seem to be pretty positive, including rather significant productivity increases continuing, which is a very positive sign.

I don't understand why the dollar is so low. Perhaps you have some explanation regarding the attitude of foreign governments and foreign private-sector investors. If you do, I would hope you would share with us that explanation as to why they feel like they do.

Somehow, I can't help but believe that the market is right and that there's some lack of confidence somewhere in terms of what we are doing, what they're fearful we won't do, or what they see in the future that we are hell-bent to do that they don't perceive as being very positive.

I think part of the trouble, using my tools, has to do with the budget deficit in the future. I can't imagine that's the whole reason, but clearly, the Administration suggested in the President's vision statement that we'd go to $150 billion as a low mark and we'd be there at the end of the decade. I think that's being re-estimated and it's now $250 billion at the end of the decade and going up.

I don't know what you think about that and why it's occurring, but I would once more share with you what I think is happening. It's a very simple proposition.

The vision statement the President issued to the American people in February 1993, this promise right here, is what the President said the deficit would look like because we were going to get health care costs under control.

The problem is that this promised deficit reduction is not going to occur because we're going to spend all of it and more for health care. So, instead of the promise being here, the promise is here, very much higher on the cost of health care, whether there is cost containment or not. The fact is, if there is any deficit reduction, it's all being spent, and more.

Perhaps you might want to address whether you think that has something to do with what people overseas, governments, individuals, and businesses, are looking at in America.

I also don't know whether you were charged with looking at the American economy and tax policy. I don't know if you're charged with looking at such things as other problems in the economy that might be causing people to worry about the American economy.

I would just close by telling you I believe you would agree that in Europe, they are very worried about the quality of their economic growth. Some economists have called what they have, Eurosclerosis. You've probably heard that before. Meaning there's some kind of enormous drag on that economy that they're equating to a very serious sickness.

I wonder if it might be possible that some looking at America, in light of this on health care, a new OSHA bill that is going to further regulate, and new regulatory burdens perking up all over the place, if they might not be looking at us, saying it will just be a few years and we'll have Americana-sclerosis. Maybe that's what's causing the problem. Thank you very much.

The CHAIRMAN. Mr. Summers, we're going to make your full statement a part of the record, and we'd like your remarks at this time.

OPENING STATEMENT OF LAWRENCE SUMMERS UNDER SECRETARY FOR INTERNATIONAL AFFAIRS DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. SUMMERS. Thank you very much, Senator.

Mr. Chairman, Members of the Committee, it's a pleasure to be here to present the Treasury Department's 1994 Interim Report on International Economic and Exchange Rate Policy.

I'd like to start with a brief review on where we are following the Naples Summit.

The President had a very productive series of meetings with other G–7 leaders, leading to a number of significant conclusions. As you can imagine, the world economy loomed large in everyone's thoughts.

Last summer, the United States had just begun its recovery, and we were still hoping for a turn-around in Europe and Japan.

At the Tokyo Summit, the G–7 endorsed a growth strategy, and that strategy has now begun to bear fruit. This year, the G–7 will have its best growth in 5 years. Germany, France, and Italy will all show positive growth this year after declines last year, and there is some reason to believe that Japan will accelerate as well. I think it's safe to say that the G–7 has now put recession behind us.

The United States leads the pack. The United States economy is growing faster than any other G–7 economy. United States job growth for this year will actually exceed the OECD total. The President's program of deficit reduction has put us on track to have the lowest budget deficit in the G–7.

More good news is that inflation in the United States and in the G–7 remains in check. We're expecting the best inflation performance in 30 years. While long-term interest rates have risen this year, it is important to remember that rates are going up everywhere and in most places, they have risen more than in the United States.

There are a number of factors. One, our growing economy has produced an increased demand for credit which has tended to push up long-term rates. The willingness of market participants to hold long positions in bonds decreased as yields rose. This year's rise has also been, in part, a correction of the remarkable decline in yields which we observed last year. Whatever the constellation of causes, it's important to remember that most experts see no reason to think that the increases to date will have adverse effects on projected real economic performance, which remains strong.

When our economy grows faster than those of our trading partners, one side effect is that we buy more than they do and our current account deficit increases. While we expect the continued cyclical lead of the United States to produce some further current account deterioration over the next year or so, the widening process will slow as growth spreads in the G–7.

In Europe, the moderate recovery now underway has so far not produced fast enough growth to significantly reduce unemploy-

ment, which is now around 12 percent. Governments there are seeking an appropriate policy mix of reducing budget deficits while providing monetary conditions conducive to recovery.

In Japan, the government recognizes the need for further stimulus. In Naples, their Prime Minister committed to keep the income tax cut in place, and to withhold an offsetting increase in consumption taxes until the recovery has strengthened. This is good news.

Next, I'd like to say a few words about recent developments in foreign exchange markets. Between mid-October of last year and early January, the dollar appreciated by 10 percent against the mark and almost 7 percent against the yen. These movements were generally attributed to continued weak economic performance in Japan and the expectation that interest rate differentials between the United States and Germany would move in favor of dollar assets.

Over the early months of 1994 these trends reversed, and the recent depreciation has drawn a good deal of attention.

Important factors in the rise of the yen and the mark were a sense that Europe was growing faster and a renewed focus on the current account imbalances of the United States and Japan. The change of government in Japan also raised questions about the new coalition's commitment to address Japan's imbalance with new policy actions.

In response to these moves, the United States, working with other major countries, intervened in exchange markets on several occasions.

On June 28th, Secretary Bentsen made our position clear when he said, "We believe a stronger dollar is better for our economy and better for the world's economy."

The recent weakness of the dollar is a complicated phenomenon with no single cause or explanation. Part of the explanation lies in the improved prospects for recovery in Europe which have dispelled past expectations about rapid declines in interest rates and created new expectations that short-term interest rates might rise. This has pushed up long-term German interest rates and has been a particular factor affecting market exchange rates.

The perception that the new Japanese government might be less able to make substantial policy changes than its predecessor has fueled speculation that a rise in the yen would be required to effect the necessary external adjustment.

The dollar has in fact been relatively stable in the past year when you look at its relationship with the currencies of all our trading partners. Indeed, on a trade-weighted basis against all trading partners, the dollar is unchanged since the Administration took office.

Of course, with the benefit of hindsight, one can point to a number of factors that affect exchange rates, but I would not want to pretend that anyone fully understands the dynamics that drive markets on a week-to-week, month-to-month basis.

What I would say is that the Administration believes that a strengthening of the dollar against the yen and mark will have important economic benefits for the United States and will restore the confidence in financial markets that is important to sustaining recovery. It would boost the attractiveness of United States assets

and the incentive for longer-term investments in the economy, and help to keep inflation low. In addition, and this view is shared by other G–7 countries, a renewed decline of the dollar could well be counterproductive to global recovery.

I want to reiterate, with a low inflation base in an investment-led recovery, in my judgment, the prospects for sustained non-inflationary growth in the United States are more favorable than they have been in a generation, and that should ultimately be reflected in the financial markets.

Next, I'd like to briefly review some regional developments. These developments are covered much more fully in the report.

Following the March 23rd assassination of Mexican Presidential candidate Colosio, the United States announced the establishment of a temporary bilateral swap facility at the request of Mexican authorities. The assassination prompted the closing of Mexican financial markets on March 24th, giving rise to concern that the reopening of the market on March 25th would be accompanied by market disorders that could spill over into United States financial markets. However, no drawings on this facility proved necessary.

On April 26th, the United States, Canada, and Mexico formed the North American Financial Group, for regular consultation on economic and financial developments and also announced the establishment of a trilateral swap facility linking the three countries.

From the beginning of its term of office, this Administration has seen the need for more vigorous economic engagement with the Asia-Pacific region. President Clinton hosted the first ever meeting of APEC economic leaders in Seattle in November of last year, and Secretary Bentsen hosted an unprecedented meeting of APEC finance ministers in Honolulu last March.

At the moment, China's economy continues to show clear signs of overheating. Real growth exceeded 13 percent last year, and prices rose at a 25 percent rate for the year ending in March 1994.

China's external situation appears to be strengthening, however, with very strong export growth exceeding import growth this year.

I'd like also to mention, as noted in the report, that China's trade numbers differ considerably from those of its trading partners and, we believe, significantly understate China's exports.

In January, Treasury was encouraged by China's decision to unify its exchange rate system and eliminate the requirement for government approval of foreign exchange purchases for trade and trade-related transactions. China also created a new interbank market where foreign exchange could be freely purchased at a market-based exchange rate for import and other transactions.

In April, however, China took a significant step backward by again segmenting its foreign exchange market. Foreign-funded enterprises, which account for 40 percent of China's imports, were excluded from the interbank market and instead must continue to face interference from the State Administration of Exchange Control.

This system clearly has the capacity to impede Chinese imports, and we therefore consider China to be manipulating its foreign exchange system in a manner which reduces the demand for imports and thereby prevents effective balance of payments adjustment.

Treasury has pursued a two-part strategy in response to these Chinese actions.

First, we have raised our concerns directly with the Chinese central bank officials.

Second, we have ensured that this issue has been emphasized in the context of discussions of Chinese GATT accession.

It remains Treasury's judgment that neither Korea nor Taiwan is manipulating its exchange rate within the meaning of Section 3004. Nonetheless, we remain concerned about certain policies in both countries and will continue to work closely on issues related to financial market liberalization.

In conclusion, Mr. Chairman, I'd like to thank you for providing me this opportunity to testify on behalf of the Treasury Department on a complex, but I think extremely important, area of economic policy.

The CHAIRMAN. Thank you for your presentation.

Where do we go next on the China problem? You've laid it out. You're obviously disappointed with what you cite here as this latest effort to effect a manipulation of the trading levels.

How do we solve this problem?

Mr. SUMMERS. We pursued this in the context of Secretary Bentsen's trip to China last winter. He made the United States position very clear and made it known that this will be a crucial issue in the context of China's accession to the GATT, which is something that I believe the Chinese very much want.

It is something which we are pushing on the Chinese authorities at every opportunity.

The CHAIRMAN. It looks as if it hasn't had much impact yet. It doesn't sound to me like that strategy is working. The numbers don't show it working.

Mr. SUMMERS. I think, Senator, there are a whole range of factors that affect Chinese markets.

If you look at the problem we've identified, which is trade barriers arising from the exchange system in China for United States exports, I think one does have to note that the increase in United States exports to China, which has been at something approaching an 18 percent rate over time, does suggest that that market is becoming more open to the United States over time and that that is an encouraging development.

Clearly, this is something that is going to have to be pursued on a continuing basis.

Frankly, I do not believe that the whole phenomenon of the Chinese surplus can be laid at the door of the foreign exchange practices, although I think that the foreign exchange practices are a distinct inhibitor of imports to China.

The CHAIRMAN. When you say in your written submission:

> Treasury therefore concludes China to be manipulating its foreign exchange system in a manner which prevents effective balance of payments adjustment.

That's a very powerful conclusion. It calls for action.

You can't say that and then not have an action plan behind it to deal with the problem.

I guess what I need to understand more clearly is, what's the action plan to deal with the problem you've just identified?

Mr. SUMMERS. Senior officials will, I am confident, visit China again this year. I will take this issue up in the context of the visit from senior Chinese financial officials that we expect sometime this fall. The remaining tool is the, I think, quite significant leverage that is afforded by the ongoing GATT negotiation, which is something that China very much wants, and, as part of being a member of the GATT, China will have to adopt an exchange rate system that is consistent with giving foreign producers an opportunity to export to China.

The CHAIRMAN. Let me ask you this. Is foreign exchange manipulation consistent with a country that has most favored nation trading status?

Are these things compatible? Can you give somebody a trading advantage that, by your own acknowledgement, is cheating in this area?

How do you square those things? It seems to me that you run right smack into yourself, going in the opposite directions.

Mr. SUMMERS. There has been no consideration of using MFN status as a lever with respect to the exchange rate manipulation issue.

The CHAIRMAN. That's my point.

Mr. SUMMERS. I would have to say, Senator, considering the various interests involved in the MFN issue, many of which I think have come out in the course of discussions of that issue in recent months, that I would not recommend to the Secretary that MFN issues be linked to foreign exchange issues.

The CHAIRMAN. I'm sure that's very comforting to the Chinese officials that are manipulating the exchange rate.

In other words, they're giving you the brush-off in this area where you identify the cheating that's going on and yet, we say, despite the fact that they're cheating in this area and they've refused to stop doing so, we're going to give them a special preferential trading arrangement.

I'm simply saying there's an inherent contradiction in that. I think it's obvious, it's glaring. I think it's awfully hard for me to see how they're going to take you very seriously when they have an abuse going on that you've identified and tried to jawbone them into correcting and they've given you the brush-off.

I don't see where there's any lever or incentive to correct this problem.

Mr. SUMMERS. Senator, I believe they value good financial relations with us, and that the GATT accession is a very important issue for them, and I believe that in managing the United States economic relationship with China, where we obviously have a variety of concerns, we need to balance those concerns appropriately.

I think that surplus does represent a very real issue. I think the foreign exchange practices which do limit some potential exports from the United States are a cause for concern, and we are pushing that cause for concern, but I would have to say that it is, I think, not a fair reading of the evidence to suggest that it is exchange rate issues that account for the lion's share of that accumulated surplus.

The CHAIRMAN. They shouldn't account for any share. It shouldn't be tolerated.

In other words, you've identified an abuse, and this isn't the first time you've identified it.

Mr. SUMMERS. That's right.

The CHAIRMAN. There's all this chit-chat going back and forth, but the abuse continues and the numbers are getting worse. Senator Sarbanes' chart shows that. This trade deficit with China is widening and that's an explosive rate of growth in trade deficit.

Senator SARBANES. At a rapid rate.

The CHAIRMAN. Are our numbers correct? Are we looking at a trade deficit with China this year of about $27 billion?

Is that where it's going to come in?

Mr. SUMMERS. That's close to right. I don't know what the precise number is.

The CHAIRMAN. We don't have to guess about what it was in 1991, because those numbers are in. According to the record, that's $12.7 billion.

So, between 1991 and this year, it's more than doubled. What's going to stop this rate of increase? Are you going to be back in here a year or two from now informing us that this deficit is up to $40 billion? $50 billion?

There's nothing in that trend line that would suggest otherwise.

I think what's happening is that they're taking a lesson from the Japanese, who have figured out how to manipulate the trading relationship very skillfully, with a variety of devices. I don't say they rely precisely on the same ones, but the Japanese have managed to build and sustain an enormous bilateral trade deficit and it continues through all phases of the business cycle. There's some adjustment in it, but there is a huge, embedded trade deficit. It's going to be over $60 billion this year just with Japan.

They're laughing at us because they've managed to do it and get away with it year after year after year. They did it with Bush and now they're doing it with this Administration.

I see China following exactly the same pattern with a different set of devices. I think they've decided that they can help their economy at the expense of our economy.

It seems to me your job, from the administrative point of view, is to devise a strategy that confronts this and changes these trend lines. I think that's part of what the last election was about, to change Administrations in order to get off these trend lines.

You've given us no evidence of any improvement in the trend line and, in effect, you're conceding that the trend line is probably going to get worse. I haven't heard you say, or give us any plausible reason to expect that a year from now, that gap is going to narrow.

If you believe it's going to narrow, please tell us.

Senator SARBANES. It's going to be worse.

Mr. SUMMERS. Senator, I can't predict where the number will be next year. I would be very surprised if, when we look at this 2 or 3 years from now, we see the fanning out on Senator Sarbanes' graph continue to fan out in the way that it has in recent years.

The reason I'd be very much surprised is that I see a tremendous upsurge in United States business activity directed at exporting to China. I expect that the 18 percent a year increase in exports to China that we've seen for a number of years will start to add up. It didn't amount to a lot, in terms of billions of dollars, at a time

when the base was quite low, but I expect that that will start to add up.

I would be surprised if you didn't see a considerably more balanced pattern of trade 2 or 3 years from now than you do right now. That would be my expectation, and I think that the gradual liberalization of the Chinese economy will be part of that process.

I would just make one other comment that I think is analytically important in understanding this phenomenon.

I think there is some tendency to see this increase in the trade surplus with China as something that is coming wholly at the expense of American producers. I think that most analysts who have looked carefully at it will tell you that a significant part, though by no means—surely not all, but a significant part of it reflects competitive advantage that was once possessed in Korea, Taiwan, or other parts of Asia, moving to China.

To understand that pattern, we tend to want to think of it as driven by factors relating to American policy, but the decision of businesses that would, in an earlier period, have located in Indonesia are now choosing to locate in China. That is another factor contributing to the pattern exhibited in that chart.

Senator SARBANES. Yes. But if Indonesia takes our exports, and we have a better trade balance, then it's to our interest that the production of those goods be done in China.

This argument is always made and the flaw in it—here's what you say. You say, "Well, if the Chinese didn't send these goods in, the Indonesians or Thailand would send these goods into the United States. We wouldn't produce them here."

You can argue about that, and some believe that some of these goods would be produced here, but let's concede that premise, that they would be produced elsewhere. If the other countries in which they were produced would be taking American exports so that we were still running a trade balance and we got an uptick on the export side for American goods, it would be better for the trade arrangement and better for our economy.

What the Chinese are doing is sending the goods in and not taking our exports. They're taking the exports of other countries—the EC, Japan. Those countries are running a surplus with China. But they're not taking our exports.

Suppose they were produced in Thailand or Indonesia, but at the same time, those countries then, exporting more to the United States, imported more from the United States. It would be to our advantage.

I apologize to my colleague.

The CHAIRMAN. I'm about to yield to Senator Bond, but I just want to make a comment in doing so, just to finish off this point, if I may.

That is, I read an article in The Washington Post yesterday entitled, "Trade Deficit Rose in May by $9.17 Billion," written by Peter Baer, who's a thoughtful writer. He says in here, and I quote:

> According to some analysts, the deficit with China could surpass that with Japan before the end of the decade if current trends continue, adding new fuel to economic tensions between Washington and Bejing.

I know you say it's going to change, but you're hoisted on your testimony here because you acknowledge on page 8 that in April,

China took a significant step backward. You've complained about it, and properly so, but then you fuzz over it in terms of saying, "Well, things may get better, anyway."

Look. Let me tell you something. I don't think things are going to get better. I think, unless there's a wake-up call somewhere that finds a stronger strategy than has been found thus far to deal with this problem, this problem is going to get a lot bigger, and the bigger it gets, the harder it is to unwind.

For what it's worth, you're getting a point of view from me, and I think you'll hear from the other Members as they express their views.

This is a big problem. It's not getting better. It's getting worse. The strategy you've employed isn't working. We need a strategy that does work, so let's try to find one.

Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

I agree with you. Those are very important questions and, I think, frankly, the questions lead to what everybody has heard and read for some time. There is concern over the consistency and the clarity of our position in international affairs, including international economic affairs.

A number of critics suggest that we have had difficulty with China because we have spent the last few months trying to poke them in the eye over human rights. There were some very difficult and very unfortunate results from a high-level visit to China by our Secretary recently.

We have, as the Chairman and the Senator from Maryland pointed out, some real concerns over their manipulation of exchange rates and our trade imbalance.

There are concerns about their human rights potential.

At the same time, there are some of us, and I guess I would include myself very definitely in that category, who think that we badly need the cooperation of the Chinese in putting sanctions, albeit economic, political, or diplomatic, on North Korea to stop the proliferation.

We've got a real smorgasbord here. Perhaps you could clarify for us what our priorities are with respect to dealing with China. How are we going to deal with them? That's a tough question. Maybe you can enlighten me.

Mr. SUMMERS. Senator, that is a very tough question. Clearly, the overall management of the United States relationship with China is not my responsibility. I think it's very clear that managing the relationship requires recognition of a number of different overlapping spheres.

One crucial overlapping sphere, as your reference to sanctions suggests, is the whole security and political sphere.

A second crucial sphere is the whole sphere of economic and commercial relations.

A third sphere is the whole range of cooperation on a variety of global issues—China's participation in international organizations, China's potential role as the largest contributor to global warming 25 years from now.

A fourth sphere is the whole sphere of American values and the expression of concern about human rights.

I don't think you can rank them or give some simple hierarchy for them, and I certainly don't think you can exclude any one of those. I think the task of statesmanship, if I might, is to try to balance those considerations.

Certainly one of the very important considerations is the one that Senator Riegle and Senator Sarbanes have stressed—the commercial relationship and the problem of an imbalance in that commercial relationship. That is something we are very much concerned about going after.

I would be less than honest with the Committee if I attempted to tell you that manipulation of the exchange system was the main reason why China had exported as much as it had to the United States or the main barrier to an increase in United States exports to China.

Even if China did what we are asking in terms of exchange rate manipulation so we could not call them an exchange rate manipulator, it would remain the case for a variety of macroeconomic reasons, a variety of trade-related reasons, that China would have a large, measured trade surplus with the United States.

I think it is appropriate for us to pursue the exchange rate manipulation issue through the appropriate channels for that issue, and that is what we are doing.

It is appropriate that the Administration use the full set of tools—Section 301, and so forth—directed at market opening to make sure that American producers are not discriminated against in their attempt to sell to China.

It is appropriate that the full set of American trade laws be used to counter any abusive practices by Chinese exporters.

That is what we are doing and, when those things are done, there will be an outcome for the trade surplus. I do not share the pessimistic vision that China's surplus with the United States will steadily increase until the year 2000.

Senator BOND. I gather that the simple answer to my question is that there is no simple answer and that this has to be judged in the context of a variety of very high priority interests. I think that is a compelling point. I think that we do have to be consistent and establish a clear-cut policy.

Let me be clear on one thing.

Near the bottom of page 2 of your written testimony, you say, "While long-term interest rates have risen this year, it appears that this reflects, to a large extent, the expectation of stronger growth rather than fears of inflation."

Do I take that to mean you don't feel there's any danger of inflation? Can we say that the low value of the dollar is totally divorced from any expectation of inflation?

Mr. SUMMERS. I think that any senior financial official of any government should always be concerned about inflation and should always be on the look-out for signs of inflation. Certainly, there have been a number of expressions of concern by various people about the possibility of inflation in the last several months.

I think if one looks carefully at the behavior of bond yields and one looks at the kinds of evidence, such as the behavior of indexed bonds in countries which would not reflect inflation expectations, and compares the increase in United States bond yields with the

increase in indexed bond yields in countries like England and Canada that have indexed bonds, and one looks at the nature of the co-movement between the bond market and the stock market, and one looks at surveys of long-term inflationary expectations by economists, and one balances that kind of information with indicators of inflationary pressure, I would have to say that I regard rising credit demands rather than inflation expectations as the dominant explanation for the increase in long-term bond yields.

My own reading of the evidence would suggest that, of the various factors that have been relevant in currency fluctuations, I would not assign a high weight to inflation expectations.

At the same time, I think, as a recovery matures and as an economy approaches the capacity range, inflation is clearly a real concern, and as Administration officials have said many times, we and the Federal Reserve share the same objectives of strong growth with low inflation.

Senator BOND. Would you, as a senior economic policy official, say that maintaining a low inflation rate is essential for long-term, sustainable, economic growth and the creation of jobs?

Mr. SUMMERS. I don't think there's any question that accelerating inflation would be extremely dangerous to the prospects for the kind of sustained, durable recovery that we want to have and that low inflation is most conducive to a stable, strong recovery, both in terms of the number of jobs that are created and in terms of the quality of the jobs that are created and the standards of living they can support.

Senator BOND. Would you agree that monetary policy has a built-in lag time, so that, to head off inflation through monetary mechanisms, you need to act as much as a year in advance to have an impact through monetary policy on potential monetary forces generating inflation?

Mr. SUMMERS. I sense you might be trying to lead the witness, Senator. There's a limit to how far this witness will go——

Senator BOND. How long does it take for monetary policy to have an impact?

Mr. SUMMERS. —but, as a technical judgment, there is no question that monetary policy impacts the real economy and the inflation rate with a significant lag that's estimated by most economists to be between 6 and 18 months.

Senator BOND. You did all right by yourself. You don't need any leading from me.

Now, asking you questions, there are two questions that really have not been addressed in your testimony that are very important to us.

What's your view of the success or failure of NAFTA? Have we had increased trade? Have we lost jobs? Have prices decreased?

Was NAFTA a good deal or a bad deal?

Mr. SUMMERS. I thought NAFTA would be a good deal, and what I've seen in the last 6 months has confirmed that view.

You look at United States exports to Mexico in the first quarter and they were up something like 15 percent, despite the fact that Mexico has run a recession.

I think that, in light of the very difficult political events in Mexico over the last 6 months, the swap line that I referred to in my

testimony made a contribution to the maintenance of stability in Mexico.

Frankly, NAFTA, and the reinforcement of reform in Mexico that it represented, made an even greater contribution to stability in a country that was crucial to us, so I think it's a great deal.

Senator BOND. Finally, you don't mention anything about Russia. Can you give us a quick shot as to your view of the economic situation in Russia and what role you see that country playing in the world economy?

Mr. SUMMERS. I'll stay away from predicting the ruble-dollar exchange rate, but I will say that, in the face of what I think are very difficult political developments in Russia, I've been quite encouraged by many of the economic changes. Russia was able to negotiate a program with the IMF this spring. Under that program, the Russian budget deficit has come down to a range of 8 or 9 percent of GNP.

That is much too high, but it is within the range of a number of western European countries.

Those reductions in the budget deficit have borne some fruit. Inflation was running at 1 percent a day a year and a half ago and inflation during June was running at about 1 percent a week, 4½ percent during June. That's surely too high, but I think we can agree that, especially when you compound those to annual rates, that represents real progress.

Russia has privatized more industries in less time than any government in the history of the world in the last year. I think that is an impressive accomplishment.

If you look at Russian wages measured in dollars, they've actually risen quite significantly. If you look at Russian wages measured relative to Russian consumer prices, they've actually increased, less significantly, but by 5 or 10 percent in the last year.

The industrial production statistics continue to be very disturbing, but it's important to understand that most of that lost industrial production represents tanks and the like and not things that people actually consumed. If you look at measures of food consumption or measures of the number of people who have a TV, those things have actually shown modest increases in the last year.

While we've got an enormously long way to go, and while there are enormous strains and enormous dislocations, and the problem of one-company towns is a particularly serious one, I would have to say that I'm more encouraged about the prospects for Russia's economic reform and its integration into the world economy than I have been at any time in a long time.

If I might just make one plug.

I think the United States is doing everything it can—I here think of pending trade legislation—to integrate the economies in transition into the world economic system. Applying our dumping law in a way that is sensitive to the problems of transition economies, would be particularly constructive in encouraging a flow of private investment into Russia.

That's an issue that I understand to be pending this week before the Congress.

Senator BOND. Mr. Summers, you have a very difficult responsibility and I appreciate the enlightening answers.

I yield back to my colleague from Maryland.

Mr. SUMMERS. Thank you.

Senator SARBANES. Thank you very much, Senator Bond.

I just want to read from your statement as you look at the China issue:

> In April, however, China took a significant step backward from these announced reforms by issuing regulations that again segmented the foreign exchange market. In particular, foreign-funded enterprises were excluded from the interbank market and instead must continue to use the swap centers to purchase foreign exchange needs that exceed export earnings.
>
> Foreign-funded enterprises therefore still face the potential for interference from the State Administration of Exchange Control in their desired foreign exchange purchases for imports and other uses.
>
> Moreover, reports indicate that the Chinese authorities are requiring foreign-funded enterprises to balance their foreign exchange earnings and expenditures. This system clearly has the capacity to impede Chinese imports and adjustment in China's trade surplus with the United States, which reached $23 billion last year.

This is an absolute, gross departure from standard rules of trade, isn't it?

Mr. SUMMERS. This represents, as I think the report says, exchange rate manipulation. I think it is one of a number of significant Chinese trade barriers that do hold back American exports.

Senator SARBANES. How is it, in light of this, that you expect these trend lines not to continue?

Mr. SUMMERS. Senator, my judgment is that a very heavy volume of foreign investment in China in recent years, combined with a very considerable increase in American business emphasis on the Chinese market, combined with what has been over time progress in bringing down trade barriers and letting businesses operate in larger parts of China, is likely to continue to produce significant double-digit percentage increases in the rate of American exports to China. As those double-digit increases take place from a larger and larger base, my expectation would be that you would start to see exports to China rise relative to imports and that there will be some decline in the Chinese trade surplus.

I also think that we——

Senator SARBANES. You expect an actual decline?

Mr. SUMMERS. I expect over the next several years that there will—over the next few years, I expect a decline in that trade surplus, yes.

Senator SARBANES. So you expect the trade imbalance to be less than $25 billion.

Mr. SUMMERS. At some point in the next several years, that would be my expectation.

Senator SARBANES. So you expect that the exports to China, as opposed to the imports from China, will be greater.

Mr. SUMMERS. Sorry. I do not expect China's deficit to be eliminated. I do expect that there will be years in which the exports will increase by more than the imports, so the deficit will decline.

Senator SARBANES. How can you do that if you don't close the gap?

Mr. SUMMERS. In hypothetical numbers, Senator, if exports rose by $4 billion and imports rose by $2 billion, the gap would close somewhat.

I'm saying that the gap will close. I'm not saying that the gap will close to zero. I'm saying that at some point in the future, I ex-

pect that exports will rise more rapidly than imports and, therefore, that the gap will close.

Senator SARBANES. All right. In the last year, how much did exports rise and how much did imports rise?

Mr. SUMMERS. Exports rose considerably more than imports in the last year.

Senator SARBANES. To China?

Mr. SUMMERS. To China, yes—I'm sorry. Excuse me. Imports from China rose considerably faster than exports to China.

Senator SARBANES. What were the figures?

Mr. SUMMERS. That's why there was the surplus increase.

Senator SARBANES. What were the figures?

Mr. SUMMERS. I don't have the figures right here. One can see them fairly accurately from your chart.

Senator SARBANES. It seems to me you're living in a fantasy land. I could understand if you sat there and said, we don't expect the imbalance to grow as rapidly as it has been growing. I don't know whether I would agree with that or not, but I could understand that statement.

Instead of jumping from—what was the trade imbalance the previous year? $18 billion, I think. Yes, $18 billion. It went from $18 billion to $23 billion. In the previous year, it went from $12 billion to $18 billion.

You're now telling me that in a couple of years' time, it's going to decrease, not increase.

Is that correct?

Mr. SUMMERS. I would expect that—these kinds of forecasts are notoriously inaccurate, Senator.

Senator SARBANES. I know. I'm trying to get at your mindset. If you come with that kind of mindset, if you're operating in what I would perceive as such an unrealistic context, it's no wonder we're having trouble coming to grips with these problems.

Mr. SUMMERS. Senator, I think the basis for my judgment, that exports are going to increase substantially, is that I expect strong United States actions in the foreign exchange system area and in using trade remedies to reduce trade barriers to China. I expect that when those trade barriers are reduced, United States exports to China will increase considerably.

It's not that I've got some view that this is going to automatically happen, but I expect it on the path that we are on. I would be very surprised if you saw continuing increases at the rate that we have seen in the past and my expectation would be that, after several years, you would start to see that trade surplus level off and then start to decline.

Senator SARBANES. The nice thing about this is you can be held to this standard. Today is July 21, 1994. You're telling us that in a couple of years——

Mr. SUMMERS. Several years.

Senator SARBANES. —these things are going to happen. We'll see.

Let me ask you, on page 4, you say, "A few facts will make it very clear, for instance, why the Clinton Administration is placing such a high priority on the Asia-Pacific region."

Then you say, "Trade between the United States and its APEC partners is 172 percent larger than our trade with the European Community."

Correct?

Mr. SUMMERS. Yes.

Senator SARBANES. What's the United States trade deficit for the last year?

Mr. SUMMERS. In 1993, the United States trade deficit was $116 billion.

Senator SARBANES. $116 billion?

Mr. SUMMERS. Yes.

Senator SARBANES. How much of that was with Japan?

Mr. SUMMERS. $59.3 billion.

Senator SARBANES. How much was with China?

Mr. SUMMERS. $23 billion.

Senator SARBANES. So, of the $116 billion trade deficit, $82 billion of it was with China and Japan.

Is that correct?

Mr. SUMMERS. That's correct.

Senator SARBANES. Taiwan?

Mr. SUMMERS. $9 billion.

Senator SARBANES. $9 billion. So we're up to $91 billion. Korea?

Mr. SUMMERS. $2.4 billion.

Senator SARBANES. So I'm at $93.4 billion. That leaves only $23 billion of the $116 billion to account for.

Is there any other country that has a large figure to help make up that $23 billion?

Mr. SUMMERS. The numbers are before me, Canada has $10.7 billion.

Senator SARBANES. They had a trade surplus of $10.7 billion?

Mr. SUMMERS. With us, yes.

Senator SARBANES. Anyone else?

Mr. SUMMERS. No. I think if you add together the various newly industrializing countries in Asia, you'd have another $8 or $9 billion.

Senator SARBANES. OK. In other words, the countries that are in APEC.

Now, I want to get at this point. When you say trade between the United States and its APEC partners, do you mean total trade, imports and exports?

Mr. SUMMERS. Yes.

Senator SARBANES. OK. Would you regard a trade relationship—I want to ask you this question, just as a hypothetical question.

You have two trade relationships, one with Country A. The total trade involved is $100 billion: $50 billion in exports and $50 billion in imports. So, you have a trade balance.

The trade relationship with Country B—the total trade relationship is $100 billion; just like the trade relationship with Country A, in the trade between the United States and its partner.

I take it that's what this phrase refers to. Is that correct, in your statement?

Mr. SUMMERS. Yes.

Senator SARBANES. But the trade relationship with Country A is $98 billion of imports from Country B and $2 billion of exports to Country B, for a trade deficit of $96 billion.

Do you regard those relationships with Country A and Country B—do you perceive the relationships with Country A and Country B in the same way, $100 billion of trade in each instance, but a very different composition as far as imports and exports are concerned?

Mr. SUMMERS. No, those would clearly be quite different relationships.

Senator SARBANES. Would you be concerned about a relationship in which we had $100 billion worth of trade and only $2 billion of it were exports and $98 billion were imports and in which we were running a $96 billion trade deficit?

Mr. SUMMERS. In general, Senator, I would find it more helpful to think about our global trade balance, which I think of as being largely determined by the difference between the amount we invest as a country and the amount we save as a country, and then I think of a variety of factors having to do with the macroeconomic balances of other countries as having to do with the allocation of that trade balance across different countries.

Senator SARBANES. Let's look at the global trade picture. I'm perfectly happy to do that.

The trade between the United States and its APEC partners, which is 172 percent larger than our trade with the European Community, left the United States with how much of a trade imbalance with APEC?

Mr. SUMMERS. I think we just calculated it somewhere in the $95 to $100 billion range. Probably slightly less than that because we had a surplus with Mexico. A deficit somewhere in the $90 to $95 billion range.

Senator SARBANES. What about with our European partners?

Mr. SUMMERS. We were very close to being in balance in 1993 with Europe. Just about even.

Senator SARBANES. You're the sort of person that, if there's a sale you have to buy it because it costs less than it did before, even though you're laying out money, aren't you?

Wouldn't a trade relationship like we have with Europe, which is in balance, be a more constructive trade relationship than one with the APEC partners, whose total amount of trade is 172 percent larger, but which results in a trade imbalance of over $100 billion?

Mr. SUMMERS. Senator, I think it's precisely concerns of that kind that explain why this Administration has made a priority of promoting our exports to Asia. Precisely because of a desire to reduce the kinds of imbalances that you describe.

It's precisely because of the kinds of concerns that you describe that we have embarked on a framework, special negotiations with Japan outside of the multilateral system.

Senator SARBANES. No, no. You don't say that here in your statement. You don't say that one reason to focus on APEC is because we're running large trade imbalances.

The point you make is, look, there's a lot of trade involved. This is the same argument we get on the China trade. People come in

and say, "Well, you know, we're exporting to China." And you say, "Well, you're exporting to China." How much are you exporting to China?

We're exporting $9 billion. It's very important to the people who do those exports but, to look at the trade picture, you've got to realize that we're importing $34 billion and we're running a trade deficit of $25 billion as a consequence.

You sit here and say, "We've got big economies out there. They're going to account for a lot of the world output. The trade with them is larger than with the European countries."

Then you say, "We get 60 percent of our imports from APEC nations. They buy approximately two-thirds of our total exports. What we're ending up with is we're running a big deficit with them."

If you had said, look, we've got to pay attention to these countries because we're running a big trade deficit with them and we've got to do something about that big trade deficit, then, we'd ask, what are you going to do? At least I'd understand.

Instead, you're coming in saying, look, we've got these big relationships here. We've got to maintain these relationships in this trade, and we're running negatives.

You want to come along and do even more? We'll run even bigger negatives. Where's the action program not to run the negatives?

Then you put down the Europeans. We run larger trade relationships with the Europeans and it's roughly in balance. Some years we run a bit of a surplus. Some years they run a bit of a surplus. It's interesting about the relationship with the EC, that it tends—well, let me ask you the question.

Does it not tend to fluctuate between surplus and deficit in a fairly narrow range?

Mr. SUMMERS. Because the savings and investment propensities in Europe are about the same, their trade has traditionally remained relatively in balance. Because we have maintained quite a low savings rate in this country, and the Asian countries have maintained an extremely high savings rate, there has been a tendency in recent years for the United States deficit to be large and for the Asian surpluses to be substantial.

I think the roots of those imbalances are to be found in the savings behavior of the two regions of the world.

Senator SARBANES. With which Asian countries do we have significant trade and are either running a trade surplus or roughly a trade balance?

Mr. SUMMERS. With most of the Asian countries, as I think I've said, we have a——

Senator SARBANES. What about Indonesia? What's your figure on Indonesia?

Mr. SUMMERS. Indonesia, minus $2.7 billion.

Senator SARBANES. In a trade relationship of what size?

Mr. SUMMERS. Our exports are about $2.7 billion and our imports are $5.4 billion.

Senator SARBANES. OK. Are we running a surplus with any of the Asian countries?

Mr. SUMMERS. We ran a small surplus with respect to Hong Kong. We ran a surplus with respect to Australia. There's no other

Asian country that's split out here where we're running a surplus, Senator.

Senator SARBANES. Do you think we can indefinitely run these large trade imbalances? Is not the consequence of them that others build up claims on us so that we then have to produce here in excess of what we can consume here in order to meet the claims?

Is that not the case?

Mr. SUMMERS. I think the crucial question——

Senator SARBANES. No, I don't want to shift. Maybe I'm wrong in this analysis and, if I am, I'd like to get, if I can, a yes or no answer to that.

Mr. SUMMERS. When we run a trade deficit, others build up claims.

Senator SARBANES. When we run trade imbalances by which other countries then establish claims on us, do we not have to produce, as it were, an excess over what we can use internally in order to meet those claims?

The CHAIRMAN. Don't we have to eventually pay our bills?

Mr. SUMMERS. If the claims rise more—I'm not trying to obfuscate—in some sense, yes, Senator. With a growing economy, as long as our debt does not rise out of line with our income, in fact, we can maintain a given level of indebtedness or even an increasing level of indebtedness. Just as, while I'm concerned about the Federal deficit——

Senator SARBANES. That's not my question to you. I understand that, but that was not my question.

My question is, if others abroad hold claims against us, do we not then have to produce, as it were, an excess margin here to meet those claims over and above what we would otherwise be free to utilize in our own country?

Is that not the case?

Mr. SUMMERS. I think it depends on the rate at which they are prepared to increase their holding of United States claims.

Senator SARBANES. Suppose there were no claims. Would there not then be freed up for internal use resources that now go to meet the claims?

Mr. SUMMERS. If foreigners suddenly forgave all their claims on the United States, that would free up more resources for American consumption, yes.

Senator SARBANES. All right. The fact that we have to pay these claims means, in effect, that resources have to be devoted to that purpose, which otherwise could be utilized internally.

Mr. SUMMERS. If we pay these claims rather than simply roll over these claims, that's correct.

The CHAIRMAN. Even if you roll them over, it's not cost-free.

Mr. SUMMERS. Any debtor would be better off without his debts.

Senator SARBANES. Thank you, Mr. Chairman.

The CHAIRMAN. Let me focus on Japan. I'm going to take the time to read about six paragraphs from Samuelson's article in yesterday's Washington Post. I want to read it all to give you the full argument that he presents, which I think is quite a compelling argument, and then I'm going to ask you your opinion about it.

It reads as follows:

Someone will some day write the definitive history of the swindle of the century. For now we must content ourselves with the bare facts.

During the 1980's, Japanese insurance companies, banks, and corporations bought hundreds of billions of dollars of foreign stocks, bonds, and real estate, often office buildings, hotels, and resorts. On these investments, the Japanese have suffered catastrophic losses, often 50 percent or more.

What's astonishing, though, is that the swindle was mostly self-inflicted. It was mainly eager Japanese buyers and not fast-talking foreign salesmen who fed the buying frenzy. All this is now relevant because it explains the yen's dramatic rise to a post-war high of 97 to the dollar. That is, it took 97 yen to buy a dollar compared to 145 back in 1990.

For most countries, a rising currency signifies growing confidence. For Japan, it's just the opposite. It represents a harsh judgment by global money managers that the Japanese cannot correct their big trade imbalance themselves and that only large exchange rate changes raising the price of Japanese exports and lowering the price of imports will do the job.

Japan's massive overseas investments merely postpone the inevitable day of reckoning—when Japan runs big trade surpluses, it collects huge amounts of foreign currency, mostly dollars that it doesn't need to buy imports. Normally, that would lead to a rapid rise of the yen as surplus dollars were sold on foreign exchange markets to buy yen.

With more sellers of dollars than buyers, the dollar drops and the yen rises.

In Japan's case, the effect was delayed because so many dollars were recycled to buy foreign bonds and office buildings. Having now suffered immense losses on these investments, the Japanese have lost their appetite for more, so the dollar drops and the yen rises.

'There is nothing mysterious about this. Yet many Japanese deny it. They think that the strong yen has been intentionally created by Washington,' writes economist Richard Koo of Nomura Securities. But in fact, the reason lies in Japan's massive $130 billion trade surplus.

'The delusion pervades Japanese society. Only last week, the Prime Minister blamed the United States for the high yen,' reports the Daily Japan Digest.

I'm going to finish now, having read only part, the first part of his article.

He then goes on to say:

The Japanese are right to fear the rising yen. They are wrong to blame others.

Is that analysis essentially correct?

Mr. SUMMERS. The emphasis on the Japanese current account as a very important factor that has influenced market psychology; the emphasis on capital flows and the pattern of capital flows into and out of Japan; the conclusion that the movement in exchange rates does not reflect American manipulation of any kind; all of that is quite correct.

The CHAIRMAN. I appreciate that. Is the other part of the argument correct that, in fact, this currency valuation issue is going to continue because they've been living with this very substantial trade surplus for such a long period of time that there is an inevitable adjustment process that is going to revalue the yen vis-a-vis the dollar?

Mr. SUMMERS. Senator, I think you can understand my reluctance to make any projection as to what will happen with respect to——

The CHAIRMAN. I'm not asking you to project.

Mr. SUMMERS. —foreign exchange markets.

The CHAIRMAN. No, I'm not asking you for projection. I'm talking about what's already happened. I'm very clear on that.

Mr. SUMMERS. The current account has, I think, been one of the important factors in what's taken place.

The CHAIRMAN. The change in the dollar-yen relationship is really, of late, quite dramatic. We've seen the move past the 100 level down to 97. A lot of people, I think, would not have predicted that months or years ago, but it's happened.

This writer has made an assertion as to what, in part, is driving that, that there is, in effect, an inevitability. He's saying that no nation can run a massive trade surplus of this kind for that long a period of time and not, in effect, have a day of reckoning where there's going to be a currency adjustment of the kind that we're now seeing.

That seems to make sense to me. Doesn't that make sense here?

Mr. SUMMERS. I think any attempt to reduce these things to a single cause that makes things inevitable is likely to be misleading with respect to currency markets. I think the preferences of asset holders around the world have a great deal to do with this.

As I said, I agree with the thesis that the market perception of the current account surplus is one of the important factors that's influenced exchange rates between the dollar and the yen.

The CHAIRMAN. I'm not sure I know, after some period of time, how else these adjustments occur, unless they occur, in part, through exchange rate adjustments.

I'm not saying it's a 1-for-1 relationship. I'm saying, when you have a massive trade surplus that runs for such a long period of time, that there's an inescapable economic logic to the fact that at some point, it's likely to help drive adjustment in currency valuations to the point that we're now seeing.

Mr. SUMMERS. Senator, as I said in my testimony, it's this Administration's belief that a stronger dollar would be desirable.

As Secretary Bentsen has said a number of times, no nation——

The CHAIRMAN. I understand that, but if the fact of the change in the differential here and, in a sense, the change in the relative value of the yen becoming stronger is for reasons beyond the control of the United States, then we can't take the burden for the argument that's saying we'd like to have a different kind of relationship, when in fact the change is being caused by factors outside of our direct control.

Mr. SUMMERS. Senator, I believe the healthiest forms of adjustment for the Japanese current account surplus would involve expansion of demand in Japan that would put money in consumers' hands and would increase the volume of imports, and a reduction in the large number of trade barriers in Japan that hold down exports.

I believe those forms of adjustment are pro-competitive and are most consistent with strong job performance and strong real incomes for American workers.

The American approach to opening the Japanese market is based on those two objectives—market opening and an expansion of demand in Japan and not—this I want to stress—not any attempt to manipulate exchange rates.

The CHAIRMAN. I think that's a very constructive comment you've just made because it seems to me the answer here lies in the Japanese not just selling a massive amount of goods in the United States, but beginning to buy a somewhat comparable amount of goods from the United States.

We sell goods every other place around the world, certainly to advanced nations. We don't encounter this problem with any other advanced nation—on this scale—other than Japan.

It has to be changed. What is happening is a bitter harvest that now is occurring. I think part of it is this exchange rate adjustment. I don't say that's the only reason that's driving it, but I think it's a major reason. The Japanese are going to have to take a fresh look at this problem and do, I think, precisely what you've laid out.

If they don't find a way to begin to buy more goods from the United States comparable to what they want to sell to the United States, these problems are going to get worse, not better.

I don't think anybody gains at the end of the day. I think that not only is harmful to them, it clearly is harmful to us. That's a lose-lose strategy.

I don't know how we get that point across because I think the writer, Mr. Samuelson, is correct in saying that there's something of an illusion, as I look at the psychology coming out of Japan, as to where this problem comes from. In a sense, a manipulated trade surplus of the size that they have managed to establish with the United States, which doesn't go away and which is running $5 billion a month net in their favor, is going to create very disruptive consequences sooner or later.

I think we're beginning to see some of those, but I don't want the fact that some of that harvest is now upon us, I don't want that taken off the radar screen and not seen as a reason, a partial reason, for what's occurring here, because if there's a lack of reality about seeing that point, then there will be a failure to move in the area where the corrections are needed and this problem will not get better. This problem will get worse and I think it will fester.

I'm concerned because there's really nobody that seems to be accountable in Japan today for economic policy. The succession of Prime Ministers lodges these issues down in a bureaucratic mattress of individuals and business practices where nobody's accountable for anything.

It's an avoiding of the adjustment process that's needed to deal with this problem.

It's hurting the United States and it's putting us in an economic hole. I don't buy the argument that we're getting in deeper, but because our economy is growing, the percentages are remaining roughly the same and so, while we're accumulating an even more massive long-term debt relationship with Japan, we can tolerate it because the percentage relationship is staying the same.

I think that's not right. I know you can make an argument to that effect, but I think it's run so long, it's so extreme, and the numbers are so large, that you begin to get a strategic weakening after a point in time and I think we run that risk.

Let me ask you one other question here.

When Alan Greenspan was here yesterday, I asked him whether he thought the dollar's decline in recent months was good or bad for the economy, on balance. He answered that he definitely thought it was bad.

Do you agree with that? If so, why?

Mr. SUMMERS. I think I made the point in my testimony, Senator, that I think the decline in the dollar has potentially adverse

consequences for confidence. It also has potentially adverse consequences for long-term investment and potentially adverse consequences for the dollar's central role in the monetary system. The cause of recovery in the United States and global recovery would be better served, as Secretary Bentsen has said a number of times, by a stronger dollar.

The CHAIRMAN. If United States interest rates were to continue to go up, what are the international economic consequences of that, as you see them?

Mr. SUMMERS. I think that's difficult to predict because it would depend on the relationship between movements in United States interest rates and movements in foreign interest rates. Depending upon the nature of the reason for the movement in United States interest rates, there might or might not be a tendency for movements in tandem abroad.

I think it's difficult, without laying out the scenario in more detail, to make a projection as to what the consequence for foreign countries would be from an increase in United States interest rates.

The CHAIRMAN. Let me ask the question a different way.

That is, if we were to get another interest rate increase now in United States rates, would that be helpful?

Mr. SUMMERS. I would not want to be in the position of prescribing as to what the Fed would do with respect to short-term rates.

The CHAIRMAN. No, I'm giving you a hypothetical question. I'm saying, if that happens, will the consequence be good or bad in the arena in which you work?

Mr. SUMMERS. Answering whether it would be desirable or undesirable for an increase in short-term rates to take place would be closer to a prescription than I'm comfortable giving.

I don't think any of us would like to see a rise in long-term interest rates.

The CHAIRMAN. I'm very much of the view, and there are different views on this Committee, that we've had some recent adjustments. There's been a change in monetary policy direction. That's obvious. Alan Greenspan confirmed that in his comments yesterday. There's also a lag in the effect of these changes and so, it takes some months before the slowing, the economic slowing effect fully kicks in.

Some of that has started because you get a change in psychology and in expectations and certain rates rise immediately. You start to see, in the housing area and the interest rate sensitive areas, a very quick effect and we're seeing some of that already.

It seems to me, as I look at your problems on the international economic side, that a further increase in American interest rates right now, it's hard for me to see how that is helpful on the margin.

You have no response beyond what you've said to that?

Mr. SUMMERS. No.

The CHAIRMAN. Do you have a mental response? A private response?

Mr. SUMMERS. I'm just very reluctant, beyond saying that we and the Federal Reserve share the same objectives, to get into making prescriptions or judgments about what would or would not be desirable in terms of the movement in short-term interest rates.

I would say that I'm very encouraged by the economic fundamentals right now in this country, low inflation and investment-led recovery, which is something that we have not had together since John Kennedy was President.

It seems to me that the priority for all of us involved in macroeconomic policy has to be to keep that combined pattern on track because the more we succeed in maintaining an investment-led recovery, the more capacity we will create in the economy and the easier it will be to maintain a strong level of demand and continued rapid employment growth.

The CHAIRMAN. I would conclude by saying to you that I think with respect to some of these international trade trend lines in these accumulations and perpetuations of these massive deficits to other countries, particularly countries that use predatory trading practices of one kind or another—you've cited specific ones that you object to in China, but you've been a little more oblique with respect to ones that persist in Japan—that I think we're hurting our economic future and our prospects. You can give away America's strength a lot of different ways. One way to do it is in relative economic terms.

I think these massive, persistent, deliberate, manipulated trade deficits have to be stopped. I don't know whether this Administration—they obviously started long before you arrived in your job or this President arrived in his job, so I respect the difficulty of the task of hitting these problems head to head and then turning them around, but if you don't get that done, I think it's going to be an enormous failure of opportunity and responsibility.

I want to emphasize how important I think it is that we find a strategy and an action plan that moves these numbers. It's one thing to say today that you think the trade deficit with China will stop increasing at some point, although you don't know when, and start to reduce itself, but I think I would like to see those numbers happen on your watch and not hand this problem off to some other poor devil who ends up taking your assignment or two or three successors down the line.

That's been the game that's been going on around here for a long time. I think the time for action is now.

Thank you.

The Committee stands in recess.

[Whereupon, at 12:23 p.m., the Committee was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

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PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Mr. Chairman, I am pleased to join you in welcoming Under Secretary Larry Summers before the Committee to testify on the Treasury Department's Report on International Economic and Exchange Rate Policy. Yesterday, the Committee heard from Federal Reserve Chairman Greenspan on the outlook for the economy. Since the global economy is making the United States and other national economies interdependent, Under Secretary Summers can fill in some important details about the dollar and exchange rates. His views and impressions about the recent G–7 meeting should be especially interesting.

Mr. Chairman, I welcome our witness and look forward to his testimony.

PREPARED STATEMENT OF LAWRENCE SUMMERS

UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
DEPARTMENT OF THE TREASURY, WASHINGTON, DC

JULY 21, 1994

Mr. Chairman and Members of the Committee, it is a pleasure to be with you here today to present the Treasury Department's spring 1994 Report on International Economic and Exchange Rate Policy. The report itself covers information available just through the end of May, with the principal exception of exchange markets, which are through June. I will, however, endeavor to provide a comprehensive overview of the current global economic situation in my remarks.

Naples Economic Summit

I would like to start with a brief report on the Naples Economic Summit. The President had a very productive series of meetings with the other G–7 leaders, leading to a number of significant conclusions.As you can imagine, the world economy loomed large in everyone's thoughts. The leaders agreed on a set of principles to guide efforts to create employment, and renewed their commitment to strengthen and sustain the recovery while maintaining low inflation. Japan agreed that tax cuts were still required to stimulate their economy. With an eye toward building the economic ties of the future, the leaders agreed to begin developing common information and communications infrastructure, ensuring more integration, openness, and competition.

Growth Strategy Beginning to Pay Off

The G–7 economies have come a long way in the past year. Last summer the United States had just begun its recovery, and we were still *hoping* for a turnaround in Europe and Japan. I told you in my testimony last spring that European recovery was "still in the distance" and that Japan needed a multi-year tax cut to stimulate its economy. At the Tokyo Summit, in July of last year, the G–7 endorsed a growth strategy that included deficit reduction in the United States, European interest rate reductions in Europe, and fiscal stimulus in Japan.

We are beginning to see the fruits of that strategy. A year later, recovery has taken firm hold in North America and the United Kingdom, and the G–7 countries as a whole will grow by a full percentage point faster than last year—the best performance in 5 years. After posting declines in 1993, Germany, France, and Italy will all show positive growth this year. We are hopeful that growth in Japan will accelerate as the new government has reiterated its commitment to cut taxes until the recovery has strengthened. I think it is now safe to say that we have all finally put the recession behind us.

The United States continues to lead the pack. The United States economy is still growing faster than any other G–7 economy despite the fact that we are further into recovery. Over 75 percent of the total growth in the G–7 in 1993 and 1994 is accounted for by the rise in United States GDP, though we account for only 40 percent of G–7 GDP. United States job growth for this year will be more than for the OECD as a whole, in contrast to another substantial fall in Europe's employment. And the President's ambitious program of deficit reduction has put us on track to have the second lowest budget deficit in the G–7, after Japan.

A most encouraging sign is that our recovery is being led by investment. Business purchases of equipment accounted for fully one third of the increase in real GDP over the past three quarters. By building capacity and investing in people, we are building the foundation for a long period of sustained growth.

More good news is that inflation remains in check. With inflation in the G–7 expected to decline below 2.5 percent for 1994, we are experiencing the best inflation

performance in 30 years. While long-term interest rates have risen this year, it appears that this reflects, to a large extent, the expectation of stronger growth rather than fears of inflation. It is also important to keep in mind that rates are going up everywhere, not just in the United States. In fact, 10-year bond yields have gone up less in the United States than in four of the other G–7 countries; only German and Japanese rates rose less.

There are a number of factors at work in this increase in long-term rates. A growing economy produced an increased demand for credit, which tended to push up long-term rates. Also, the willingness of market participants to hold long positions in bonds decreased as yields rose, prompting additional sales that accelerated the rise. This year's rise has also been, in part, a correction of the remarkable *decline* in yields which we observed last year. Whatever the constellation of causes, it is important to remember that we see no reason to think that the increases to date will have adverse effects on the real economy in this country.

When our economy grows faster than those of our trading partners, one side effect is that we buy more than they do and our current account deficit increases. It is important to note that the deterioration we have in fact seen recently is related to this cyclical pattern and not to any underlying weakness in the United States competitive position. While we do expect the continued cyclical "lead" of the United States to produce some further deterioration over the next year or so, the widening process should slow as growth spreads to more of the G–7 countries. As a result, the deficit is likely to stabilize as the cyclical factors recede and is not a significant source of concern.

In Europe, the moderate recovery now underway has so far been led by exports, but there are signs that growth is spreading to domestic sectors as well. Unemployment in Europe, though, is averaging 12 percent, and the economy is unlikely to grow fast enough over the near term to bring that down significantly. Governments there are seeking an appropriate policy mix that recognizes the twin goals of further progress on reducing budget deficits in some countries, while providing monetary conditions conducive to a stronger recovery.

In Japan, the government has recognized the need to take a continued stimulative stance and has indicated it will do so. Government investment has been the most consistent source of growth for some time, though consumer spending has begun to strengthen. While the new government is still getting itself settled, we were told in Naples that it remains committed to using fiscal policy to spur growth. Specifically, the Prime Minister committed to keep the income tax cut in place, and to withhold an offsetting increase in consumption taxes until the recovery has strengthened. Indications are that Japan's current account surplus has peaked and has started to decline. Volume data, which will show adjustment before value data, indicate that there is a further decline in the pipeline.

It has become even clearer over the past year that United States economic interests increasingly lie beyond the G–7. Some have viewed the United States push for NAFTA, and now the talk about expanding NAFTA southward, as a similar turn inward from the world. Similarly, many Europeans especially view the Clinton Administration's emphasis on the Pacific rim and the Asia-Pacific Economic Cooperation (APEC) forum, as a turn away from Europe. This points out a unique problem that the United States faces as the sole remaining super power. We have bilateral relations with every region and nearly every country in the world; in most cases, the other country views the United States as its most important bilateral partner. We must be careful to maintain a balanced approach.

At the same time, we must seek out the markets and pursue the policies that will provide the greatest benefit to the American people. A few facts will make it very clear, for instance, why the Clinton Administration is placing such a high priority on the Asia-Pacific region:

- East Asia includes some of the fastest growing economies in the world.
- Even without the United States and Japan, APEC countries could account for one-quarter of world output by the year 2000.
- Trade between the United States and its APEC partners is 172 percent larger than our trade with the European Community.
- We now get 60 percent of our imports from APEC nations, and those countries buy approximately two-thirds of our total exports.

Foreign Exchange Markets

Next, I would like to say a few words about recent developments in foreign exchange markets. Over the course of the past 9 months, the dollar first appreciated versus the yen and the mark, then depreciated. Between mid-October of last year and early January, the dollar appreciated by 10 percent against the mark and almost 7 percent against the yen. These movements were generally attributed to con-

tinued weak economic performance in Japan and the expectation that interest rate differentials between the United States and Germany would move in favor of dollar assets.

Over the early months of 1994, however, these trends reversed. This recent depreciation has drawn a lot of attention, and I'd like to discuss a bit the specifics of our policy and actions over this period.

Between early January and the end of June, the dollar declined by 8 percent against the mark and 13 percent against the yen. The most important factors in the rise of the yen and the mark were a reassessment of the pace of economic recovery in Europe and a renewed focus on the external imbalances of the United States and Japan. The change of government in Japan also raised questions in the markets about the new coalition's ability and willingness to address Japan's current account surplus with new policy actions.

In response to these moves, the United States, working with other major countries, intervened in exchange markets on several occasions:

- On April 29, we sold several hundred million dollars of marks and yen. Secretary Bentsen said at the time that we were concerned about volatility and were moving to "counter disorderly market conditions."
- On May 4, we participated in a concerted intervention involving 18 other countries. Secretary Bentsen announced at the time that the Administration saw "no advantage in an undervalued currency."
- Finally, on June 24, we joined 16 other countries in a further significant sale of other currencies.

On June 28, Secretary Bentsen made our position as clear as it could be, when he said: "We believe a stronger dollar is better for our economy and better for the world's economy."

The recent weakness of the dollar is a complicated phenomenon with no single cause or explanation.

- Prospects for recovery have improved in Europe, dispelling past expectations that interest rates would fall further and creating new expectations that short-term rates would rise. This has pushed up long-term German rates, in particular, and strengthened the mark.
- The change of government in Japan has reinvigorated concern about the Japanese current account surplus. The perception that the new government might be less able to make substantial policy changes than its predecessor has fueled speculation that a rise in the yen will be required to effect the necessary external adjustment.
- The dollar has in fact been relatively stable in the past year when you look at its relationship with the currencies of *all* our trading partners. It is mainly unchanged since the Administration took office.

The Administration believes that a strengthening of the dollar against the yen and mark would have important economic benefits for the United States. It would restore the confidence in financial markets that is important to sustaining recovery. It would boost the attractiveness of United States assets and the incentive for longer-term investment in the economy, and help to keep inflation low. In addition, we believe—and this view is shared by other G–7 countries—that a renewed decline of the dollar would be counterproductive to global recovery.

The prospects for sustained non-inflationary growth in the United States are more favorable than they have been at any time in a generation, and should be reflected in a strong and stable United States dollar.

Next, I would like to review some regional developments, starting with Mexico, then moving to China, Korea, and Taiwan.

North American Financial Group

Following the March 23 assassination of Mexican Presidential candidate Colosio, the United States announced the establishment of a temporary bilateral swap facility at the request of the Mexican authorities. The assassination had prompted the closing of Mexican financial markets on March 24, giving rise to concern that the reopening of the market on March 25 would be accompanied by market disorders that could spill over into United States financial markets. However, no drawings on this facility proved necessary.

On April 26, the United States, Canada, and Mexico formed the North American Financial Group, for regular consultation on economic and financial developments and policies in the three countries. These arrangements had been planned earlier in recognition of the three countries' increasingly interdependent economic relationships, particularly NAFTA. In connection with the creation of the North American

Financial Group, the monetary authorities also announced the establishment of a trilateral swap facility to expand the pool of potential resources available to each to maintain orderly exchange markets.

China, Korea, and Taiwan

From the beginning of its term of office, this Administration saw the need for more vigorous economic engagement with the Asia-Pacific region. President Clinton took the bold step of hosting the first ever meeting of APEC economic leaders in Seattle in November of last year to initiate important consultations at the highest level. We are working hard to make APEC a real force for trade and investment liberalization in the region. And Secretary Bentsen has initiated a broadened APEC dialogue covering macroeconomic and capital market developments through hosting an unprecedented meeting of APEC finance ministers in Honolulu in March of this year.

Within the APEC group, certain East Asian economies like China, Korea, and Taiwan are not only growing rapidly; they have become important players in the global economy. Their external policies matter to the global system as well as to the United States economy. We must therefore engage them regularly and consistently to promote trade and exchange liberalization. That means using all available and appropriate multilateral, regional, and bilateral means—the GATT, APEC, the OECD, and the international financial institutions—as well as bilateral negotiations.

China is in the midst of a period of fundamental economic reform to transform itself to a market-oriented economy. The United States has every interest in trying to help shape that transformation and promote China's steady integration with the global market economy.

In addition to the challenge of reform, China faces the associated challenge of maintaining macroeconomic stability. China's leaders know well that controlling inflation is essential to maintain the political and economic basis momentum for reform. We saw, for example, that the inflationary threat at the end of last decade resulted in a costly, temporary halt in reform progress and a return to government controls.

At the moment, China's economy continues to show clear signs of overheating. Real growth exceeded 13 percent in 1993 and remains in double digits this year. Prices in major cities rose at the rate of 25 percent for the year ending in March 1994. While Chinese authorities are generally seeking to maintain tighter control over credit, they have indicated that they will loosen access to credit for certain loss-making State enterprises.

China's external situation appears to be strengthening, however, with very strong export growth exceeding import growth this year. Reserves have risen $8 billion since end-December 1993. I would also like to mention, as noted in the report, that China's trade numbers differ considerably from those of its trading partners and, we believe, significantly understate China's exports.

In January of this year, Treasury was encouraged by the announcement of a major reform of China's foreign exchange regime, along the lines which we had urged during 1993 negotiations. China's dual exchange rates were unified, and the Chinese announced that government approval would no longer be required for foreign exchange purchases for trade and trade-related transactions. This appeared to be a dismantling of the system of foreign exchange restrictions which had impeded Chinese imports, including imports from the United States. China's authorities announced the creation of a new interbank market for foreign exchange where foreign exchange could be freely purchased at a market-based exchange rate for import and other transactions.

In April, however, China took a significant step backward from these announced reforms by issuing regulations that again segmented the foreign exchange market. In particular, foreign-funded enterprises were excluded from the interbank market and instead must continue to use the swap centers to purchase foreign exchange needs that exceed export earnings. Foreign-funded enterprises therefore still face the potential for interference from the State Administration of Exchange Control in their desired foreign exchange purchases for imports and other uses. Moreover, reports indicate that the Chinese authorities are requiring foreign-funded enterprises to balance their foreign exchange earnings and expenditures. This system clearly has the capacity to impede Chinese imports and adjustment in China's trade surplus with the United States, which reached $23 billion last year. I would note in this context that treatment of foreign-funded enterprises is not a small issue. They account for 40 percent of total Chinese imports. Treasury therefore concludes China to be manipulating its foreign exchange system in a manner which prevents effective balance of payments adjustment.

Treasury has pursued a two-part strategy in response to Chinese actions in this area. First, we have raised our concerns directly with Chinese central bank officials. In my negotiations with them, I have stressed our disappointment with the April regulations, our continued concern over the large and rising bilateral imbalance, and our firm position that China should establish a single, unified foreign exchange market with free access to foreign exchange for both domestic and foreign enterprises.

Second, we have emphasized this issue in the context of China's GATT accession negotiations. GATT rules require countries to refrain from using exchange restrictions which substitute for trade barriers which are to be liberalized in the context of entering the GATT. In our view, China's current system is not compatible with this obligation.

It remains Treasury's judgment that neither Korea nor Taiwan is manipulating its exchange rate within the meaning of Section 3004. Nevertheless, Treasury remains concerned about certain financial and foreign exchange policies in both countries, particularly capital controls, which discourage investment and impede the operation of market forces in exchange rate determination. Treasury will continue to work closely with Korea on these issues as it implements its 5-year financial sector liberalization plan and with Taiwan in the context of its GATT access process. Regarding Korea's financial liberalization, I would like to welcome Korean Finance Minister Hong's recent statement that Korea will implement the financial sector liberalization plan 1 or 2 years ahead of schedule to facilitate OECD entry.

Thank you.

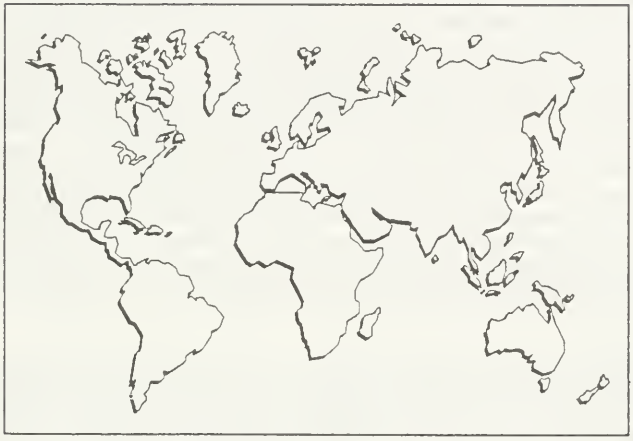
DEPARTMENT OF THE TREASURY

INTERIM REPORT TO CONGRESS

ON

INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

JULY 1994



Embargoed for release until
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PART I: SUMMARY AND CONCLUSIONS

This Report discusses recent developments in U.S. international economic policy, including exchange rate policy, since the sixth annual Report to Congress submitted in November 1993. It is based on information available through May 1994 except for foreign exchange developments, which are described through June. These reports are required under Sections 3004 and 3005 of the Omnibus Trade and Competitiveness Act of 1988 (Trade Act).

The outlook for the industrial economies has brightened considerably since the last report. Recovery is now firmly established in North America and the United Kingdom. The U.S. economy is flourishing, and Canada and the UK are expected to show satisfactory growth this year and next. In continental Europe and Japan, positive real growth is expected this year, though the pace of recovery remains comparatively weak.

Significant progress has been made on the inflation front. Inflation is under control throughout the G-7, even in those countries showing the greatest acceleration in growth. Inflation in the G-7 is expected to average 2.8 percent in 1994, the lowest level since the early 1960s. Particularly notable are essentially stable inflation in the United States; continued very low inflation in Japan and Canada; Italy's remarkable achievement in reducing inflation to very moderate levels; and the sharp decline forecast for German inflation. In countries where output remains well below potential, this progress towards price stability provides room for use of monetary policy to strengthen and sustain the expansion. In countries where the recovery has matured, policy has to be oriented to preventing acceleration of inflation that could threaten to curtail the expansion.

Despite the growing sense of optimism about recovery and output growth, unemployment remains alarmingly high and is still rising in much of Europe, particularly among the young, and people are staying unemployed longer. There are over 35 million unemployed in the OECD countries, 22 million of whom are in Europe alone. Over the past several business cycles, we have seen unemployment in Europe ratchet ever higher in the slumps and drop less during recoveries. With each iteration, part of the cyclical joblessness has become structural.

At the Naples Economic Summit, the G-7 reaffirmed their commitment to take action to sustain the expansion with low inflation. The European participants committed to further action on the fiscal front to create the conditions that would permit more flexibility on monetary policy. Japan committed to maintain the recent income tax cut and not put in place increases in other, offsetting taxes while the economy remained weak. And, building on the employment conference in Detroit, the G-7 leaders agreed on an action plan to reduce structural unemployment which focusses on investment in human capital, reduction of rigidities in labor markets, fostering innovation and spread of technology, removing barriers to competition and encouraging opportunities in new areas such as protection of the environment.

The pattern of recovery has been associated with some deterioration in the U.S. current account position, but virtually all the increase in the U.S. deficit during this period has been cyclical in nature -- the consequence of comparatively rapid growth in the United States relative to that of our major trading partners. Japan's external surplus appears to have peaked, and there is some evidence in recent volume numbers to suggest that further declines are likely.

Recent developments in the exchange markets have been a cause of considerable concern. By the end of June, the dollar had declined by 13 percent against the yen and 9 percent against the mark since the beginning of the year. Both the pace and the extent of these movements were unusual when set against the backdrop of a general improvement in the fundamental outlook for the U.S. economy. Given the rise of the dollar against the currencies of many of our other major trading partners the dollar has been relatively stable since the beginning of the year when measured on a trade-weighted basis. Nevertheless, the Administration has expressed concern over the dollar's recent movements against the major currencies, noting that they have not been in line with fundamental conditions and that a stronger dollar would be desirable.

Treasury has reviewed the foreign exchange systems and exchange rate policies of China, Taiwan and Korea -- countries with an important role to play in promoting a healthy, open global economy and adjustment in external imbalances. This assessment examines whether these countries are manipulating their exchange rates within the meaning of Section 3004 of the Trade Act, to prevent effective balance of payments adjustment or gain unfair competitive advantage in international trade.

It remains Treasury's judgment that neither Korea nor Taiwan is manipulating its exchange rate within the meaning of this provision. Nevertheless, Treasury remains concerned about certain financial and foreign exchange policies in both countries, particularly capital controls, which discourage investment and impede the operation of market forces in exchange rate determination.

Treasury welcomes China's decision to unify its dual exchange rates as of January 1, 1994. Nonetheless, further reforms implemented on April 1, 1994 segmented the foreign exchange market and imposed restrictions that limit foreign-funded enterprises' access to foreign exchange. Based on China's continued reliance on foreign exchange restrictions, it is Treasury's judgment that China manipulates its exchange system to prevent balance of payments adjustment and gain unfair competitive advantage. Treasury urges the Chinese authorities to eliminate the segmentation of the foreign exchange market and restrictions on access to foreign exchange. Such steps would facilitate imports and promote adjustment in China's large bilateral trade surplus with the United States.

PART II: GLOBAL ECONOMIC DEVELOPMENTS

A. ECONOMIC SITUATION IN THE G-7 COUNTRIES

Growth

Real GDP growth in the G-7 countries continues to show a clear distinction among patterns of solid expansion in North America and the UK, some signs of slow recovery in continental Europe, and continued weakness in Japan.

The U.S. recovery is flourishing, led by investment which will expand capacity and extend the duration of that expansion. Canada continues firmly on an expansionary path. The International Monetary Fund (IMF) now projects (see Table 1 below, which also shows the broadly similar average forecast by the June edition of *Consensus Forecasts*) U.S. real GDP growth for 1994 of 3.9 percent on a year-over-year basis (3.2 percent over the year to the fourth quarter of 1994), slowing to 2.6 percent in 1995. Canada's growth is expected to accelerate to 3.5 percent this year and 4.1 percent in 1995.

Table 1
G-7 Real GDP Growth
(% change y/y)

	1993	1994F		1995F	
		IMF	Consensus	IMF	Consensus
United States	3.0%	3.9%	3.7%	2.6%	2.9%
Japan	0.1	0.7	0.7	2.3	1.9
Germany*	-1.2	0.9	1.6	2.1	2.5
France	-1.0	1.2	1.8	2.6	2.7
United Kingdom	1.9	2.5	2.8	2.8	2.8
Italy	-0.7	1.1	1.6	2.5	2.4
Canada	2.2	3.5	3.5	4.1	3.8
Total G-7	1.5	2.5	2.6	2.5	2.7

* All Germany

F=Forecast; source:IMF, World Economic Outlook, April 1994; Consensus Economics, Consensus Forecasts June 1994

Growth in Japan has been very weak, although there have recently been some signs of recovery. The current slowdown is the worst since the end of postwar reconstruction, taking into account the very low growth also recorded in 1992 (1.1 percent) and projected for this year. Even the 1995 projections would suggest a very weak recovery, and may be on the optimistic side.

The sharp rise in public sector investment in 1992 and 1993 under the fiscal expansion programs has compensated only in part for the weakness in private consumption and the two-year decline in private plant and equipment investment. The February fiscal package -- which includes income tax cuts as well as additional public infrastructure spending -- will be helpful, but will not fully compensate for other sources of weak domestic demand.

The outlook for continental Europe is slightly more encouraging, but the recovery forecast for this year is still quite modest for this stage of the business cycle and too weak to prevent further increases in unemployment. For the European Union (EU) countries other than the UK, the IMF projects only 1.0 percent aggregate growth this year, after an 0.8 percent decline in GDP in 1993.

Output Gap

The gap between actual and potential output has been growing in Japan, France, Germany and Italy, and declining in the United States, Canada and the UK. Table 2 below shows IMF estimates of this gap for the major countries. While these calculations are crude and the precise numbers somewhat questionable, the relationships and directions are indicative. These gaps are expected to remain sizeable outside the United States, despite narrowing in 1995.

Table 2
G-7: Output Gaps
% of potential GDP

	1993	1994	1995
Canada	-5.2%	-4.6%	-3.6%
France	-3.5	-4.5	-4.4
Germany	-1.8	-3.1	-3.2
Italy	-3.9	-4.7	-4.2
Japan	-3.5	-5.3	-5.6
UK	-5.3	-4.9	-4.2
US	-0.9	+0.1	+0.2

Source: IMF

Inflation

Inflation has been declining in most G-7 countries, and low inflation for the G-7 group is likely to continue. IMF and *Consensus* projections for consumer price increases (see Table 3 below) show inflation at the lowest aggregate rates since the early 1960s, excepting only the year 1986, when world petroleum prices were cut in half.

Particularly notable in these projections are essentially stable U.S. inflation rates; continued very low inflation in Japan and Canada; Italy's remarkable achievement in reducing inflation to very moderate levels; and the sharp decline forecast for German inflation. Measures of German inflation have been distorted by the impact of some increases in value added and other consumption taxes that enter the consumer price index. As the impact passes from the index, and as tight German monetary policy achieves success in reducing the rate of wage and price increases, German inflation has declined. Consumer prices in western Germany were up only 3.0 percent in the year to June; the IMF projections indicate a significant decline in the rate of increase over the course of this year and into 1995.

Table 3
G-7 Consumer Price Inflation
(% change y/y)

	1993	1994		1995	
		IMF	Consensus	IMF	Consensus
United States	3.0%	2.8%	2.7%	3.2%	3.3%
Japan	1.3	0.9	0.7	0.9	0.8
Germany*	4.7	3.0	2.9	2.2	2.2
France	2.1	1.9	1.8	2.1	2.1
United Kingdom**	3.0	3.2	2.6	3.0	3.5
Italy	4.3	3.8	3.9	3.1	3.7
Canada	1.9	0.5	0.7	1.7	1.8
Total G-7	2.8	2.4	2.3	2.5	2.7

* All Germany for IMF; western Germany for Consensus
** For UK , consumer prices excluding mortgage interest in IMF projections

Global Rise in Long-term Interest Rates

Yields on long-term government bonds increased during the first half of 1994. For the United States, the rise was about 150 basis points. Increases of between 100 to 200 basis points were recorded on ten-year benchmark issues in Japan, France, Germany and Italy, and by over 200 percent in Canada and the United Kingdom. During the first part of this period, the rise was largely synchronized across national markets. In the latter part, movements were more divergent.

A number of factors underlay the rise in long-term rates. Expectations regarding future developments in real economic growth and inflation were affected

by adjustments of monetary policy in the United States and Europe and by new economic data. Also, the willingness of market participants to hold long positions in bonds decreased as yields rose, prompting additional sales that augmented the rise. It is generally thought that the substantial decline in yields during 1993, reflecting the build-up of long positions by a variety of market participants, created the potential for a substantial correction.

It is not possible to specify with precision the relative importance of the various factors; however, the generalized rise in yields is consistent with the improved outlook for economic growth in the United States and in most other major countries. Stronger growth is associated with greater demand for credit, and thus with higher interest rates in real terms. Although faster growth also tends to be associated with rising inflationary expectations, there is no evidence to date of accelerating price increases in the United States, and inflation also remains under control in other countries.

External Account Developments

The pattern of recovery in the industrial world has been accompanied by some deterioration in the U.S. external deficit and by pressures that have limited the extent of adjustment of Japan's external surplus. Japan's trade and current account surpluses have remained high as a result of the continued stagnation of demand in Japan combined with strength in Japan's export markets in North America and Asia. U.S. external deficits are rising once again, as the U.S. expansion continues to pull in imports while growth in our export markets in Europe and Japan remains slack. IMF and *Consensus* projections for the G-7 are shown in Table 4.

Table 4
G-7 Current Account Balances
($ billions; % GDP in parentheses)

	1993		1994F			1995F		
			IMF		Consensus	IMF		Consensus
United States	-104	(-1.6)	-140	(-2.1)	-130	-166	(-2.3)	-135
Japan	+131	(+3.1)	+133	(+3.0)	+123	+126	(+2.7)	+103
Germany*	-21	(-1.2)	-13	(-0.7)	-15	-11	(-0.5)	-7
France	+17	(+1.0)	+10	(+0.8)	+9	+13	(+1.0)	+7
United Kingdom	-16	(-1.7)	-19	(-2.0)	-17	-20	(-1.9)	-19
Italy	+8	(+1.1)	+26	(+2.7)	+15	+31	(+3.1)	+17
Canada	-24	(-3.5)	-15	(-2.6)	-19	-14	(-2.4)	-16
Total G-7	-9	(-0.1)	-17	(-0.1)	-34	-40	(-0.2)	-50

* All Germany
F=forecast; source: IMF, World Economic Outlook, April 1994
Consensus Economics, Consensus Forecast

Relative national growth rates are a key to understanding these changes in current account balances. For Japan, the IMF currently is projecting (see Table 1) real GDP growth of only 0.7 percent for 1994, after 0.1 percent in 1993. In contrast, growth in important export markets for Japan is projected to be far above these rates: 3.9 percent in the United States (after 3.0 percent in 1993); 3.5 percent in Canada (vs. 2.4 percent in 1993); and 7.5 percent in Asian developing countries (vs. 8.4 percent in 1993). It should not be surprising that, under these conditions, the volume of Japan's imports grew only 1.4 percent in 1993, while export volume grew 1.6 percent despite the sharp rise of the yen (12 percent in real trade-weighted terms over the course of 1993).

In the United States, strong growth in imports in the face of relatively weak export performance, especially to Europe and Japan, contributed to rising trade and current account deficits. Strong export growth to Japan and Western Europe had been a major factor in the 1987-91 decline in our deficits. Despite a continued solid U.S. competitive position, the weak outlook for growth in Europe and Japan will hamper U.S. export growth until recovery strengthens, and the U.S. recovery will continue to pull in imports.

The developments in external imbalances, however, are not by themselves a significant cause of concern. Indeed, the large capital inflows associated with the external deficit enable the United States to maintain a higher level of investment than it could do if solely dependent on domestic saving, helping to strengthen our recovery. The U.S. current account deficit is expected to stabilize as the negative forces associated with growth differentials recede. Moreover, given the strength of U.S. investment, the buildup of debt associated with our current account deficits should not pose a problem.

B. DEVELOPMENTS IN THE FOREIGN EXCHANGE MARKET

Fluctuations of the Dollar against Individual Currencies

The dollar appreciated against the German mark and Japanese yen in the first half of the period covered in this report. From mid-October until end-December, the dollar rose in nominal terms by six percent against the mark and by four percent against the yen. Meanwhile, the mark depreciated by two percent against the yen. Against other currencies, the results were mixed. The dollar depreciated very slightly against the Canadian dollar and the Mexican peso. Latin American currencies generally tracked dollar movements, with some exceptions such as Brazil. Key Asian currencies also followed the dollar, although the floating Singapore dollar depreciated.

Flows out of yen were attributed to continued economic weakness in Japan and political uncertainty related to the new coalition government. Demand for dollars vs. marks was related to expectations that interest rate differentials would move in favor of dollar assets. During the final quarter of 1993 and first quarter of 1994, acceleration of the U.S. economic recovery contrasted sharply with continued weakness in the real economy in Europe.

In the early months of 1994, however, these exchange rate trends reversed course. Over the period from end-1993 until end-June the dollar declined in nominal terms by nine percent against the mark and by 13 percent against the yen. Over this same period, the mark depreciated by 4 percent against the yen.

However, the dollar appreciated by 4 percent against the Canadian dollar and by almost 10 percent against the Mexican peso. Other Latin American currencies were steady, with the exception of Brazil's and Venezuela's. After the Venezuelan Government introduced exchange rate and price controls on June 27, the Venezuelan bolivar took a third large step in its depreciation since mid-April. On July 1, Brazil introduced a new currency linked to the dollar as part of a broader price stabilization policy. The dollar depreciated by 4 percent against the Singapore dollar, but showed little change against other Asian currencies. Table 5 shows the percent change in the dollar against various currencies since October 15, 1993.

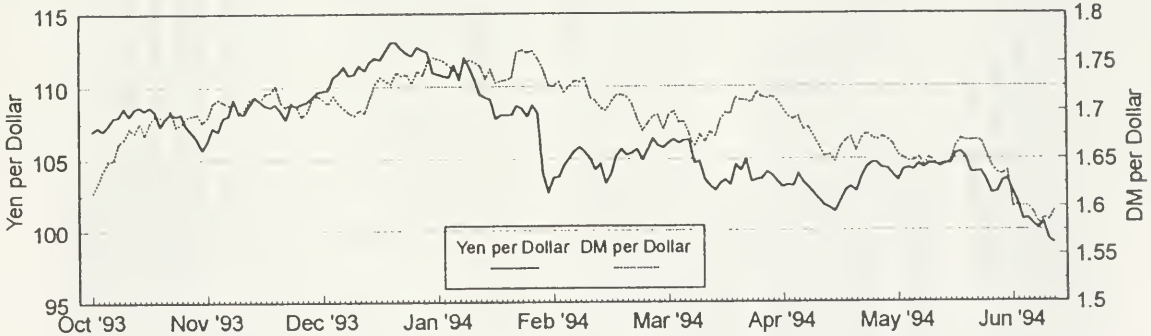
Table 5
Change in Dollar vs. Selected Currencies
(Percentage Change)

	Change from 10/15/93 to 12/31/93	Change From 10/15/93 to 6/30/94
Japanese Yen	4.4%	-7.4%
German Mark	6.5	-1.3
British Sterling	2.1	-1.8
French Franc	2.5	-4.5
Italian Lira	6.7	-0.4
Canadian Dollar	0.7	4.1
Swiss Franc	3.3	-5.9
Mexican Peso	-0.2	9.0
Korean Won	-0.6	-0.7
Taiwan Dollar	0.3	-0.2

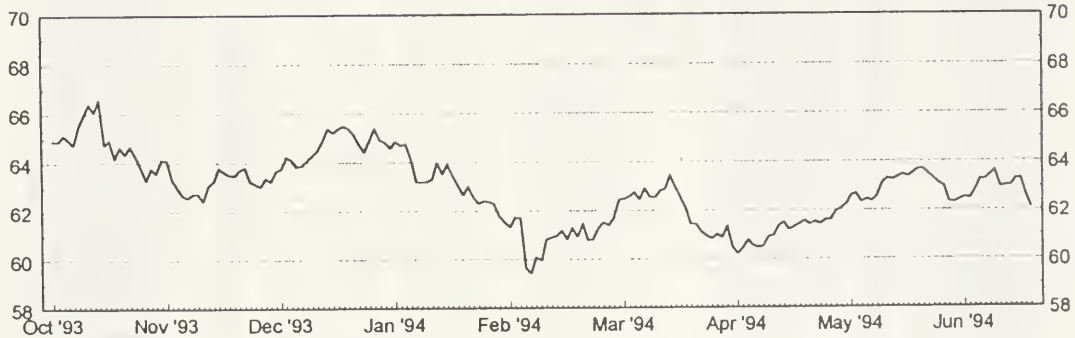
The most important factors behind the rise of the yen and the mark this year were a reassessment of the pace of economic activity in Europe and a renewed focus on the external imbalances of the United States and Japan. Emerging indications of economic recovery in Germany dampened market expectations about the extent of monetary easing there and about prospects for declines in German yields relative to U.S. yields. Japanese political uncertainties raised questions as to whether Japan's external surplus would be addressed. The widening of the U.S. current account deficit and continued diversification by U.S. investors into foreign assets raised questions about prospects for financing the deficit.

In addition to these underlying fundamental factors, market participants remained sensitive to progress in discussion of trade issues between the United States and Japan and to the reception of U.S. officials to the stimulus measures announced by Japan in early February. Dollar movements also were affected at times by market dynamics and volatility in other asset markets.

Nominal Exchange Rates
October 15, 1993 through June 30, 1994
Dollar vs. Yen and DM



Yen per DM

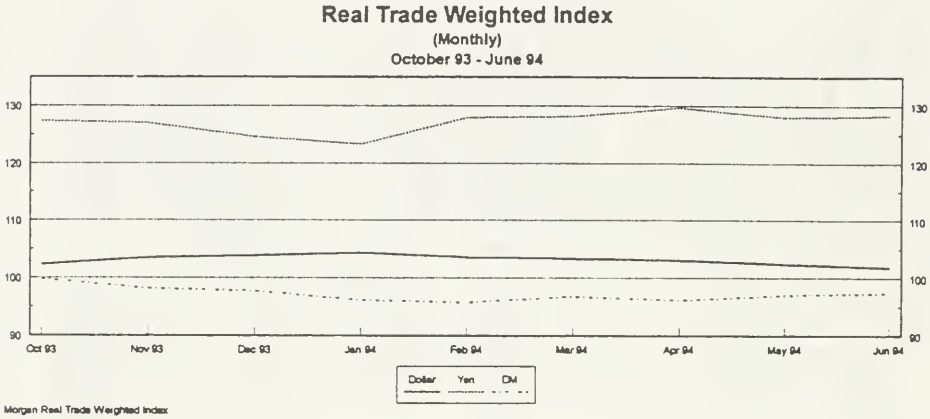


Source: Reuters daily New York opening levels.

The dollar's depreciation accelerated in April and spread beyond the yen to encompass European currencies as well. Political uncertainty in U.S.-Japan trade relations increased following Prime Minister Hosokawa's resignation. Meanwhile, the narrowing of interest rate differentials between the United States and Germany seemed to have run its course after the Bundesbank made an unexpected cut in interest rates on April 14 and the Federal Reserve hiked rates on April 18.

Fluctuations of Major Currencies on a Trade-weighted Basis

Taken over a time period of two to three years, the dollar and the German mark have fluctuated moderately on a trade-weighted basis, while the Japanese yen has greatly appreciated. However, from mid-October 1993 through June 1994 the dollar has registered a decline of some 2 percent, while the mark has remained little changed and the yen has appreciated by 3.0 percent.



North American Financial Group

Following the March 23 assassination of Mexican presidential candidate Colosio, the U.S. monetary authorities announced on March 24 the establishment of a temporary bilateral swap facility at the request of the Mexican authorities. The assassination had prompted the closing of Mexican financial markets on March 24, giving rise to concern that the reopening of the market on March 25 would be accompanied by market disorders that could spill over into U.S. financial markets. However, no drawings on this facility proved necessary.

On April 26, the U.S., Canadian, and Mexican monetary authorities announced the creation of the North American Financial Group, a forum for regular consultation on economic and financial developments and policies in the three countries. These arrangements had been planned earlier in recognition of the three countries' increasingly interdependent economic relationships, particularly NAFTA.

In connection with the creation of the North American Financial Group, the monetary authorities also announced the establishment of a trilateral swap facility to expand the pool of potential resources available to each to maintain orderly exchange markets. The United States and Mexico put in place swap agreements for up to $6.0 billion. The Bank of Canada and the Bank of Mexico expanded an existing swap agreement to Canadian $1.0 billion. The Federal Reserve and the Bank of Canada reaffirmed their existing $2.0 billion swap agreement. Each party has reciprocal privileges to make drawings of the others' currencies under this facility.

Operations in the Foreign Exchange Market and U.S. Policy

In response to the currency movements in the spring and to market perceptions about U.S. exchange rate policy, the U.S. monetary authorities, in cooperation with other major countries, intervened on Friday, April 29 in support of the dollar. Secretary Bentsen also issued the following statement:

> The U.S. monetary authorities intervened today in foreign exchange markets to counter disorderly market conditions. This is in line with our previously articulated policy, which recognizes that excessive volatility is counterproductive to growth. We stand ready to continue to cooperate in foreign exchange markets.

The U.S. authorities sold $500 million equivalent of marks and $200 million equivalent of yen on that morning.

On Sunday, May 1, Secretary Bentsen said in a television interview that "what we're concerned about is volatility in the market" and that the U.S. authorities intervene "when we see the market move away from what we think are the underlying economic realities."

The April 29 intervention operation was followed on May 4 by a concerted intervention operation involving the U.S. monetary authorities and the authorities of 18 other countries. The U.S. monetary authorities sold $750 million equivalent of marks and $500 million equivalent of yen. These operations were accompanied by a further statement from Secretary Bentsen:

"I am concerned by recent developments in the exchange markets. This Administration sees no advantage in an undervalued currency. The monetary authorities of the major countries are joining this morning in concerted intervention. These operations reflect our view that recent movements in exchange markets have gone beyond what is justified by economic fundamentals."

These operations demonstrated that the G-7 are prepared to act quickly, and in concert, in response to deteriorating conditions in foreign exchange markets.

Subsequently, the Bank of Japan accommodated a decline in market interest rates to record low levels; the Bundesbank lowered its discount and Lombard rates by 50 basis points each; and the Federal Reserve raised its presumed Fed funds rate target and discount rate by 50 basis points each. These actions were followed by a short period of relative stability of exchange rates.

However, in early June, the dollar's decline resumed. Political uncertainties in Japan were growing. The market was increasingly cautious about the end of the monetary easing cycle in Europe and about upside risk to European growth forecasts. With market participants' views growing more bearish, the U.S. authorities responded with a series of statements reiterating the Administration's concern, and on June 24 the U.S. monetary authorities and the authorities of 16 other countries made coordinated intervention purchases of dollars. The U.S. authorities sold $610 million equivalent of yen and $950 million equivalent of marks, and Secretary Bentsen said

"Our actions today in cooperation with our G-7 partners and other monetary authorities reflect a shared concern about recent developments in financial markets. We look forward to continued cooperation to maintain the conditions necessary for sustained economic expansion with low inflation."

On June 28, Secretary Bentsen stated

"We believe a stronger dollar is better for our economy and better for the world's economy. The dollar is not a tool of our trade policy. No country can be indifferent to a fall in its currency."

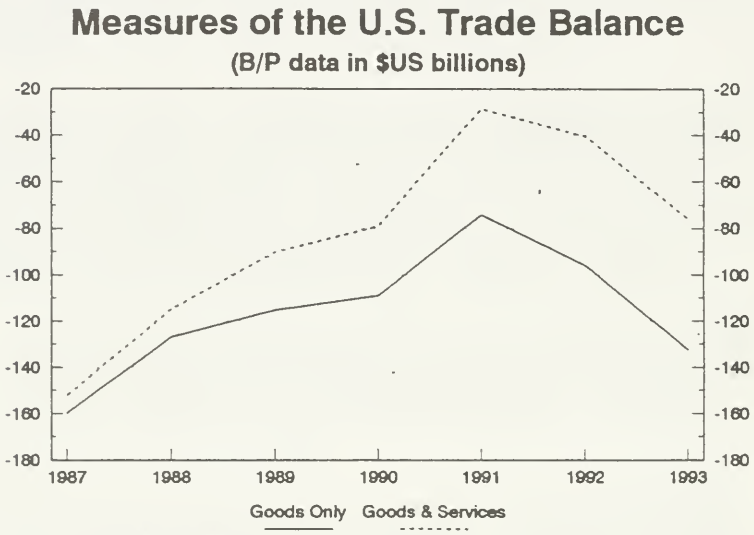
The Administration believes that a stronger dollar would have important economic benefits for the United States. It would restore the confidence in financial markets that is important to sustaining recovery. It would boost the attractiveness of U.S. assets and the incentive for longer-term investment in the economy, and help to keep inflation low. In addition, we believe -- and this view is shared by other G-7 countries -- that a continuation of recent movements in exchange markets would be counterproductive to global recovery.

The prospects for sustained noninflationary growth in the United States are more favorable than they have been at any time in a generation, and should be reflected in a strong and stable U.S. dollar.

C. Balance-of-Payments Developments

Trade Developments in 1993

Services have become a major component of international trade in recent years, in terms of both size and rapid growth. This development has been particularly important for the United States, as services are an area where the United States is a world leader, and trade in services has recorded large and rising surpluses in recent years while goods trade -- which has received much more attention -- has recorded large deficits. Thus any complete discussion of U.S. trade performance has to take account of developments in services as well as goods.



Source: Survey of Current Business, June 1994

The 1993 deficit on goods and services (G&S) trade was $75.7 billion, up from $40.4 billion in 1992. The widening of the deficit was entirely due to a larger deficit on goods trade; there was a slight increase in the already large surplus on services transactions.

Cyclical Influences.

The 1993 goods trade balance reflected a continuation of the primarily cyclical factors noted in the November 1993 Report. The U.S. goods deficit for the full year (balance-of-payments basis) was $132.6 billion, up from $96.1 billion for 1992. Exports totalled $456.9 billion, up $16.5 billion (under 4 percent) as weak demand in Europe and Japan was only partially offset by strong export growth to Latin America and East Asia, which avoided recession. Reflecting the solid U.S. expansion during 1993, imports rose $53 billion (nearly 10 percent) to $589.4 billion. Import growth was broadly based across a range of manufactures and industrial materials. Capital goods, including computers, accounted for roughly one-third of the increase.

Growing Role of Developing Countries.

Table 6 shows shifts in the geographic pattern of goods trade since 1991, when the United States had its lowest annual trade deficit since 1983. The solid competitive position of U.S. goods meant that exports could keep pace as long as the market itself was growing. In developing economies where growth was strong -- notably in Asia and certain countries in Latin America -- the goods trade deficit was flat or declining. In those industrial regions where growth was weakest, notably in Europe and Japan, the deficit widened. The notable exception to this pattern, of course, was China, where exports rose substantially (albeit from a low base) but imports rose by nearly two-thirds.

Table 6
U.S. Goods Trade with Selected Areas: 1991, 1993
($billion; data from Survey of Current Business)

Country	Exports to		Imports from		Balance	
or Region	1991	1993	1991	1993	1991	1993
W. Europe	116.8	111.3	102.0	121.0	+14.8	-9.7
Japan	47.2	46.9	92.3	107.3	-45.1	-60.5
China	6.3	8.7	19.0	31.5	-12.7	-22.8
Asian NIEs	44.4	50.1	59.2	64.5	-14.9	-14.5
L. America	63.3	78.2	63.0	75.2	+0.3	+3.0
Canada	85.9	101.2	93.0	113.0	-7.1	-12.1
OPEC*	13.8	14.2	25.3	24.2	-11.4	-10.1
Rest of Wld	39.2	46.3	37.1	52.8	-1.9	-5.9
TOTAL	416.9	456.9	491.0	589.4	-74.1	-132.6

*excl. Venezuela, which is included in Latin America

Current Account Follows Trade Deficit

The widening trade deficit was reflected in the current account balance, as trade is by far the largest and most volatile component. Table 7 shows data for the peak deficit year of 1987, for 1991 (post-1987 low point) and for 1993.

Table 7
U.S. Current Account: 1987; 1991; 1993
($billion; data from SCB)

Balance	1987	1991	1993
Goods and Services	-152	-28	-76
Investment Income	+8	+15	+4
Transfers	-23	-35*	-32
Current Account	-167	-49*	-104

* Excludes $42 billion in one-time transfers from allies to support Desert Storm. Totals do not add due to rounding.

The succession of large current account deficits -- which began in the early 1980s and is not expected to be broken in the near future -- has eroded the U.S. net investment position abroad and, inevitably, our net investment earnings. In consequence, the surplus on net investment income which has been characteristic of the U.S. balance of payments throughout the post-WWII period has disappeared, leaving services as the only offset to adverse swings in the goods deficit.

Turning to the capital account, U.S. investors substantially increased their purchases of foreign assets in 1993, in the form of both portfolio and direct investments. U.S. purchases of foreign securities were about 2-1/2 times total equivalent purchases for 1992; direct investment outflows were about 40 percent above 1992 levels. Net flows of U.S. official capital were negligible.

Foreign purchases of U.S. securities also rose substantially -- over 50 percent -- compared with 1992. Foreign direct investment inflows, which declined substantially in 1992, recovered somewhat in 1993, though they remain well below the very high annual levels of 1987-90.

Table 8
Capital Flows, 1992-93
Selected Transactions, $billion

	1992	1993
Direct Investment	-31.1	-36.5
(Inflows)	(+9.9)	+21.4)
(Outflows)	(-41.0)	(-57.9)
Securities	+21.6	-15.1
(Inflows)	(+66.7)	(+104.9)
(Outflows)	(-45.1)	(-120.0)
Official	+44.8	+70.2
Foreign	(+40.9)	(+71.6)
U.S.	(+3.9)	(-1.4)
Banks, net	+38.9	+46.9
Other	-6.3	+38.4
TOTAL	+67.9	+103.9

Source: Survey of Current Business

Prospects for 1994.

As in 1993, relative growth performance in the U.S. and major foreign economies will continue to dominate the trade and current account outlook for 1994. The U.S. economy will continue to expand, albeit at a more sustainable pace, while the prospect is for only modest recovery in Europe, and the timing of a recovery in Japan remains a question mark. In consequence, the U.S. trade and current account deficits should continue to widen at least through the remainder of 1994. Data through April are consistent with this outlook. The deficit could widen further in 1995, though at a slower pace as import growth moderates with the slower pace of U.S. growth, and exports pick up with stronger demand in Europe and, perhaps, Japan.

The evidence from data on costs and export performance indicates that the competitive position of U.S. goods remains solid, so that U.S. exports should respond well to stronger growth abroad. There has been substantial progress made in reducing the federal budget deficit, which should be reflected in improved national saving performance and a smaller external deficit than would otherwise be the case. However, sustained declines in the external deficit, beyond the reversal of cyclical effects in prospect, will require further improvements in U.S. saving performance.

PART III: ACTIONS UNDER SECTION 3004

Section 3004 of the Omnibus Trade and Competitiveness Act of 1988 requires the Secretary of the Treasury to consider whether countries manipulate the rate of exchange between their currencies and the U.S. dollar for the purposes of preventing effective balance of payments adjustment or gaining competitive advantage in international trade. Section 3004 also requires the Secretary to undertake negotiations with those manipulating countries that have material global current account surpluses, and significant bilateral trade surpluses with the United States. This section summarizes the current status of Korea, Taiwan, and China, countries that have in past reports been designated as manipulating the rates of exchange between their currencies and the U.S. dollar.

Korea and Taiwan

It remains Treasury's judgement that neither Korea nor Taiwan is manipulating its exchange rate within the meaning of Section 3004 of the Omnibus Trade Act of 1988. Nevertheless, Treasury remains concerned about certain financial and foreign exchange policies in both countries, particularly capital controls, which discourage investment and impede the operation of market forces in exchange rate determination.

Korea

The Korean won remains roughly unchanged since Treasury's last report in November 1993. Korea's trade surplus with the United States rose slightly from $2.0 billion in 1992 to $2.3 billion in 1993, while the country's overall current account balance moved into a small surplus of $500 million.

Korea's strong economic performance and initial stock market-opening steps resulted in large capital inflows in 1993 and early 1994. Concern about the effect of these inflows on monetary growth and inflation prompted authorities to seek to stem the capital inflows by imposing exchange controls early in 1994 which placed onerous requirements on foreign investors and succeeded in dampening these inflows.

Treasury continues to engage the Korean government as it implements its five year financial sector liberalization plan. Having set its sights on achieving OECD membership by 1996, the Korean Government has recently announced that financial sector liberalization will be accelerated to accomplish that goal. This plan includes projected steps to liberalize controls on capital flows and current account payments, including regulations that limit payback periods to only a fraction of international norms, and access of foreign financial institutions to Korea's financial

markets. Treasury will continue to engage in negotiations with the Korean Government to achieve satisfactory results in these areas.

Taiwan

The New Taiwan dollar also remained roughly constant against the U.S. dollar since Treasury's November report. Adjustment in Taiwan's external surpluses continued. Taiwan's overall current account surplus fell to $5.8 billion in 1993 from $8.2 billion in 1992. The shrinkage stems from slow recovery in Taiwan's export markets as well as increasing competition from other exporting economies in the region. Taiwan's trade surplus with the United States declined slightly from $9.4 billion in 1992 to $8.9 billion in 1993.

While Taiwan has incrementally relaxed certain limitations on foreign exchange transactions and capital flows, the pace of reform has been very slow. Key restrictions on Taiwan's financial markets, which constrain pressure for NT dollar appreciation, remain in place. Of particular concern in recent months has been the ceiling on foreign institutional investment inflows. By December 1993, foreign institutional investment was nearing the $5 billion ceiling. Taiwan's authorities waited until March 5 before raising the ceiling to $7.5 billion, but, at the same time, they set a new limit of $2.5 billion for capital raised on foreign stock markets by local securities investment trust companies (these funds were not previously subject to any limit).

Building on its existing bilateral talks with Taiwan, Treasury has raised these issues in the context of Taiwan's current GATT accession negotiations. In particular, Treasury is engaging in negotiations with Taiwan's authorities regarding liberalization of Taiwan's financial markets. Treasury will participate in GATT negotiations regarding a special exchange agreement, which is aimed at ensuring that Taiwan's foreign exchange regime does not impede trade and investment. Treasury hopes that these issues can be addressed expeditiously in the GATT accession process.

China

Treasury welcomes China's decision to unify its dual exchange rates as of January 1, 1994. Nonetheless, further reforms implemented on April 1, 1994 excluded foreign enterprises from the interbank foreign exchange market and imposed restrictions that limit their access to foreign exchange. Based on China's continued reliance on foreign exchange restrictions that could limit imports, it is Treasury's judgement that China manipulates its exchange system to prevent effective balance of payments adjustment and gain unfair competitive advantage in international trade. Treasury urges the Chinese authorities to eliminate the segmentation of the foreign exchange market and restrictions on access to foreign

exchange. Such steps would facilitate imports and promote adjustment in China's large bilateral surplus with the United States.

Trade and Economic Developments

According to Chinese customs figures, China's trade balance deteriorated from a surplus of $4.4 billion in 1992 to a deficit of $12.2 billion in 1993 while China's current account deficit was approximately $9.6 billion in 1993. However, China's reported current account deficit was more than offset by a net capital inflow of $20.5 billion. As a result, at end-December 1993, China's foreign exchange reserves stood at $49.9 billion (equivalent to 6 months of imports), up from $38.2 billion at end-June 1993.[1] China's external debt remains modest. Total external debt stood at $77 billion at the end of 1993 while China's debt-service ratio was 12 percent. Chinese trade figures suggest that China's external position has improved somewhat in 1994. For January-March 1994, China's exports increased faster than imports, resulting in a trade deficit of $1.3 billion.

Table 9
Chinese Balance of Payments Figures
($ Billions)

	1990	1991	1992	1993	Q I 1994
Trade Balance	8.7	8.2	4.4	-12.2	-1.3
Current Account	12.0	13.3	6.4	- 9.6	na
Capital Account	3.3	8.1	-0.2	20.5	na
Net Errors & Omissions	-3.1	-6.8	-8.3	- 9.1	na
Increase in Reserves (- = increase)	-12.0	-14.5	2.1	- 1.8	na

Source: Chinese and IMF Statistics

However, China's trade data are inconsistent with those of its trading partners. Chinese figures probably significantly underestimate exports as the requirement that exporters sell foreign exchange to designated banks creates incentives for exporters to hold foreign exchange offshore. In 1992, for example, China reported total exports of $85 billion while partner countries reported imports from China of $134 billion. Some of this discrepancy arises from: 1) valuation differences (China reports f.o.b. exports while partners report c.i.f. imports); and 2) goods transshipped through Hong Kong and counted as imports by both Hong Kong and China's other trading partners. However, even after adjusting for these

[1] This figure includes reserves of the People's Bank of China ($23.1 billion) as well as the Bank of China ($25.8 billion). China does not include the latter in its official reserve figures.

factors, partner countries report $9 billion more in Chinese exports than China reports as exports.

According to U.S. data, China's trade surplus with the United States increased from $18.3 billion in 1992 to $22.8 billion in 1993. U.S. exports to China rose 18 percent to $8.8 billion while U.S. imports from China rose 23 percent to $31.5 billion. U.S. consumption of low cost, labor intensive goods produced by China continues to grow rapidly. Footwear, toys, apparel, and plastic goods constituted the fastest growing categories of U.S. imports from China. On the export side, U.S. exports of capital goods are increasing most rapidly. Automobiles, telecommunications equipment, aircraft, and specialized industrial machinery constituted the fastest growing categories of U.S. exports to China.

In 1993, China continued to grow rapidly. China's GDP grew 13.4 percent in real terms while real industrial production rose 30 percent and retail sales rose 35 percent in nominal terms. Rapid growth was caused by high fixed investment and accommodating monetary policy. Nominal fixed investment by state enterprises increased 58 percent in 1993 while broad money increased 24 percent. Loose monetary policy led to high domestic demand and increasing inflation. The retail price index rose 18 percent for the year ending in December 1993 while the cost of living in 35 cities rose 24 percent.

The authorities attempted to slow the economy in July 1993 with a 16-point austerity program. This program achieved some initial results as real industrial production fell from 30 percent for the year ending June 1993 to 16 percent for the year ending October 1993. However, credit problems in state enterprises forced the central government to ease credit. The People's Bank of China reportedly increased base money by 150 billion yuan in September and October.

In the first quarter of 1994, economic activity moderated somewhat but nonetheless remained strong. Real GDP rose at a 12.7 percent annual rate. Industrial production was up 19 percent in real terms for the year ending in March 1994 while nominal retail sales increased 24 percent. The nominal growth of fixed investment by state enterprises declined to 36 percent for the same period. While production has slowed, inflation continues to rise. For the year ending in March 1994, retail prices rose 24 percent while the cost of living in 35 cities rose 25 percent. The government is now attempting to tighten the money supply, largely through administrative measures. The government has also resorted to price controls on basic commodities and services in an attempt to slow inflation.

China's Foreign Exchange System

On January 1, 1994 China unified its dual exchange rates at the more depreciated swap center rate and announced it would abolish swap centers in

favor of an interbank market for foreign exchange. The new, unified exchange operates as a managed float, with the People's Bank of China (PBOC) setting each day's exchange rate according to market conditions and relative to the price for foreign exchange on the previous day. While domestic firms are still required to surrender their foreign exchange, China announced that government approval would no longer be required for purchases of foreign exchange for trade and trade-related current account transactions. Moreover, companies are allowed to purchase foreign exchange automatically from designated banks upon presentation of: 1) an import contract; 2) a request for payment from a foreign institution; and 3) an import license (if required).[2]

On March 26, 1994 the Chinese Government issued new foreign exchange regulations that went into effect on April 1, 1994. In many areas, the new foreign exchange regulations are in line with previous announcements. Chinese firms are permitted to buy foreign exchange for specified purposes upon presentation of required documents. Permitted transactions include purchase of foreign exchange to buy imported inputs, to repay foreign debt, and to remit dividends abroad. However, the Chinese authorities segmented China's foreign exchange market by excluding foreign-funded enterprises from the new interbank market for foreign exchange. While Chinese firms may purchase foreign exchange through designated banks (which in turn trade through the interbank market), foreign-funded firms must use the existing swap centers.

The new regulations maintain the requirement that foreign enterprises balance their foreign exchange earnings and expenditures. Foreign-funded enterprises that have a deficit or surplus of foreign exchange may trade in the swap centers but only with other foreign-funded enterprises. The Chinese authorities have also indicated that the State Administration of Exchange Control (SAEC) must approve individual foreign exchange transactions and has the authority to deny access to foreign exchange for purposes that do not accord with national policy. However, there are no clear public regulations stipulating the conditions under which foreign-funded enterprises can purchase foreign exchange.

Exchange Rate Developments

In 1993, China's administered exchange rate depreciated less than one percent from 5.75 yuan/dollar to 5.80 yuan/dollar. China's more market-oriented swap rate depreciated 19 percent, rising from 7.30 yuan/dollar at the end of 1992 to 8.71 yuan/dollar at the end of 1993.

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[2] In 1992, 53 broad categories of goods accounting for 25 percent of China's total imports were subject to licensing.

On January 1, 1994, China's dual exchange rates were unified at the rate of 8.72 yuan/dollar. The unification represented an effective depreciation of 7.2 percent as enterprises previously importing goods at the administered rate were forced to use the more depreciated swap rate. As of end May, the unified exchange rate had appreciated slightly to 8.68 yuan/dollar. After dropping for several years, China's real effective exchange rate against the dollar has remained steady in the last two years. Nominal depreciation of the renminbi was offset by higher inflation in China than in the United States.

Table 10
China: Nominal Exchange Rate Index
(End of Period)

	1990	1991	1992	1993
United States	100	96.4	80.2	68.9
Japan	100	88.7	73.7	56.7
EC	100	98.9	91.1	84.8

Table 11
China: Real Exchange Rate Index
(End of Period)

	1990	1991	1992	1993
United States	100	97.2	83.9	82.4
Japan	100	99.9	78.8	70.5
EC	100	98.6	93.8	101.3

Exchange Rate Negotiations

On April 21, 1994, the Treasury Department held negotiations with the People's Bank of China in the context of the Exchange System Reform Working Group of the Joint Economic Committee.[3] Treasury welcomed the unification of China's exchange rate and moves to make the renminbi convertible for trade and trade-related transactions. However, Treasury noted that certain measures appeared to be a step backward from China's initial reform plans. In particular, the exclusion of foreign-funded enterprises from the interbank market and the enforcement of foreign exchange balancing requirements could restrict access to foreign exchange. The requirements that foreign-funded enterprises use swap

[3] The Joint Economic Committee is a forum for the U.S. and Chinese governments to exchange views on economic issues of mutual concern. After a lapse of seven years, the Joint Economic Committee was revived in modified form in a meeting chaired by Treasury Secretary Bentsen and Minister of Finance Liu in Beijing on January 21, 1994. Both sides agreed to the formation of new working groups to discuss monetary and banking issues, exchange system reform, and investment.

centers and that the SAEC must approve access to the centers have the potential to act as barriers to trade and thus could increase China's bilateral trade surplus with the United States. The Chinese authorities were urged to eliminate these restrictions as soon as possible. Treasury noted that elimination of restrictions would facilitate China's move toward current account convertibility, improve the efficiency of China's economic system, and promote further reform of the Chinese economy.

Assessment

Treasury welcomes unification of China's exchange rates as an important step that will facilitate China's GATT accession and movement toward full convertibility on the current account. At the same, Treasury remains concerned that restrictions on access to foreign exchange remain. In particular, the denial of foreign funded enterprises' access to the interbank market and the enforcement of foreign exchange balancing requirements could be used to reduce imports, including those from the United States. Moreover, there are no clear public regulations stipulating the conditions under which foreign funded enterprises may purchase foreign exchange. If the Chinese exchange rate comes under pressure, the SAEC could use its authority to deny foreign funded enterprises' access to the swap centers and maintain the stability of the renminbi. Thus, it is Treasury's view that China continues to manipulate its foreign exchange system.

Treasury will continue to negotiate with the People's Bank of China bilaterally and in the GATT accession context to promote further reform of China's exchange system aimed at achieving a market-oriented system of exchange rate determination and foreign exchange allocation.

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APPENDIX 1 - OMNIBUS TRADE AND COMPETITIVENESS ACT OF 1988 (H.R. 3)

SEC. 3004. INTERNATIONAL NEGOTIATIONS ON EXCHANGE RATE AND ECONOMIC POLICIES.

(a) Multilateral Negotiations.--The President shall seek to confer and negotiate with other countries--

(1) to achieve--

(A) better coordination of macroeconomic policies of the major industrialized nations; and

(B) more appropriate and sustainable levels of trade and current account balances, and exchange rates of the dollar and other currencies consistent with such balances; and

(2) to develop a program for improving existing mechanisms for coordination and improving the functioning of the exchange rate system to provide for long-term exchange rate stability consistent with more appropriate and sustainable current account balances.

(b) Bilateral Negotiations.--The Secretary of the Treasury shall analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade. If the Secretary considers that such manipulation is occurring with respect to countries that (1) have material global current account surpluses; and (2) have significant bilateral trade surpluses with the United States, the Secretary of the Treasury shall take action to initiate negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar to permit effective balance of payments adjustments and to eliminate the unfair advantage. The Secretary shall not be required to initiate negotiations in cases where such negotiations would have a serious detrimental impact on vital national economic and security interests; in such cases, the Secretary shall inform the chairman and the ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Senate and of the Committee on Banking, Finance and Urban Affairs of the House of Representatives of his determination.

SEC. 3005. REPORTING REQUIREMENTS.

(a) Reports Required.--In furtherance of the purpose of this title, the Secretary, after consultation with the Chairman of the Board, shall submit to the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate, on or before October 15 of each year, a written report on international economic policy, including exchange rate policy. The Secretary shall provide a written update of developments six months after the initial report. In addition, the Secretary shall appear, if requested, before both committees to provide testimony on these reports.

(b) Contents of Report.-- Each report submitted under subsection (a) shall contain--

(1) an analysis of currency market developments and the relationship between the United States dollar and the currencies of our major trade competitors;

(2) an evaluation of the factors in the United States and other economies that underlie conditions in the currency markets, including developments in bilateral trade and capital flows;

(3) a description of currency intervention or other actions undertaken to adjust the actual exchange rate of the dollar;

(4) an assessment of the impact of the exchange rate of the United States dollar on--

(A) the ability of the United States to maintain a more appropriate and sustainable balance in its current account and merchandise trade account;
(B) production, employment, and noninflationary growth in the United States;
(C) the international competitive performance of United States industries and the external indebtedness of the United States;

(5) recommendations for any changes necessary in United States economic policy to attain a more appropriate and sustainable balance in the current account;

(6) the results of negotiations conducted pursuant to section 3004;

(7) key issues in United States policies arising from the most recent consultation requested by the International Monetary Fund under Article IV of the Fund's Articles of Agreement; and

(8) a report on the size and composition of international capital flows, and the factors contributing to such flows, including, where possible, an assessment of the impact of such flows on exchange rates and trade flows.

(c) Report by Board of Governors.--Section 2A(1) of the Federal Reserve Act (12 U.S.C. 225a(1)) is amended by inserting after "the Nation" the following: ", including an analysis of the impact of the exchange rate of the dollar on those trends".

SEC. 3006. DEFINITIONS.

As used in this subtitle:

(1) Secretary.--The term "Secretary" means the Secretary of the Treasury.

(2) Board.--The term "Board" means the Board of Governors of the Federal Reserve System.

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